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FRAMEWORK BUILDUP OF FDI ENTRY MODE SELECTION FOR CHINA'S  
STATE-OWNED ENTERPRISE IN EU

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## **ABSTRACT**

In the recent years, the world saw a rapid expansion of China's foreign direct investment (FDI). From the start of the new century, EU as one of the world's largest economies has enjoyed rocketing growth of FDI inflow from China. As the main force in foreign investment operations, Chinese state-owned enterprises (CSOE) are eager to extend their business to Europe. The issue of investment entry mode selection has been regarded as one of the most important questions that all investors need to answer during decision making process. Study of FDI entry mode selection, therefore, is of great significance for Chinese state enterprise entrepreneurs and investors.

With a combination of qualitative method and SWOT analysis, this paper attempts to conduct a systematic study on potential FDI entry mode influencing factors from two perspectives: Chinese state-owned enterprises as ordinary firms and as special government enterprises. It aims at building a macro-level framework of FDI entry mode selection for China's state-owned enterprises investing in EU and providing theoretical solutions in optimum entry mode selection for their decision makers.

Major findings of the paper are as follows: Chinese state-owned enterprises in machinery, textile, light industry and electric appliance sectors should take wholly-owned Greenfield or partly-owned Greenfield investment when entering EU market; Technology, innovation, and brand effect oriented Chinese government enterprises are advised to go under M&A; Chinese state enterprises with the aim of access to foreign natural resource reserves could be most benefited from partly-owned

M&A entry mode; Chinese state-owned enterprises with more EU investment experience are in advantageous positions in employing Greenfield; Chinese state-owned enterprises with globalisation development strategies are recommended to employ wholly-owned Greenfield while Chinese state firms with localization strategies would be advised to use partly-owned M&A; Chinese state-owned enterprises with purposes to gain access to Western European high-tech clusters should adopt M&A; other state-owned enterprises with gradual expansion strategy should go Greenfield in EU emerging markets.

**Key Words: FDI entry mode, Chinese State-owned Enterprise, Greenfield, Merger and Acquisition, Framework Build-up**



## **CHAPTER ONE: INTRODUCTION**

### **1.1 Research Background**

Along with the deepening of globalization, the entire world sees an unprecedented booming expansion of Foreign Direct Investment (FDI). FDI has become a crucial factor for the strategic development of enterprises all over the world. In the recent 30 years, many Chinese enterprises have started to realize the importance of international markets and foreign investment opportunities. In the meantime, the increasing FDI has also enabled Chinese enterprises to further internationalize themselves and consequently they start to participate in overseas investment operations. The most important economic integration in the world, European Union, is now beginning to attract the attention of Chinese investors.

According to the “2009 Statistical Bulletin of China’s Outward Foreign Direct Investment”, which is issued jointly by the Chinese Ministry of Commerce, National Bureau of Statistics, and State Administration of Foreign Exchange (SAFE), by the end of 2009, 12,000 Chinese enterprises have engaged in investment projects in over 13,000 foreign firms in 177 countries around the globe. The net outflow of Chinese FDI is 245, 75 billion US dollars, and the total value of overseas assets has gone beyond 1 trillion dollars.

As is shown in **Table 1-1**, the proportion of China’s FDI (non-financial) to EU is not

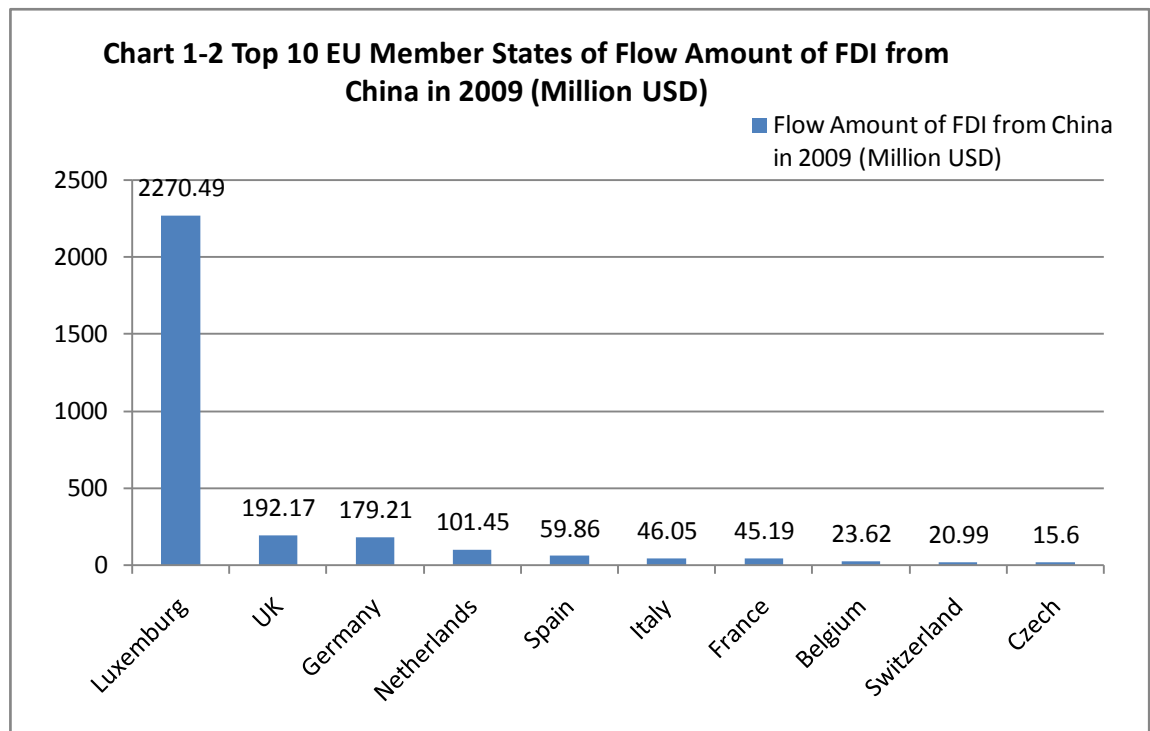
high in the total amount. But we could still see a general trend of upward growth.

***Table 1-1 Non-financial direct investment of China, net amount (Billion USD).  
2004-2009***

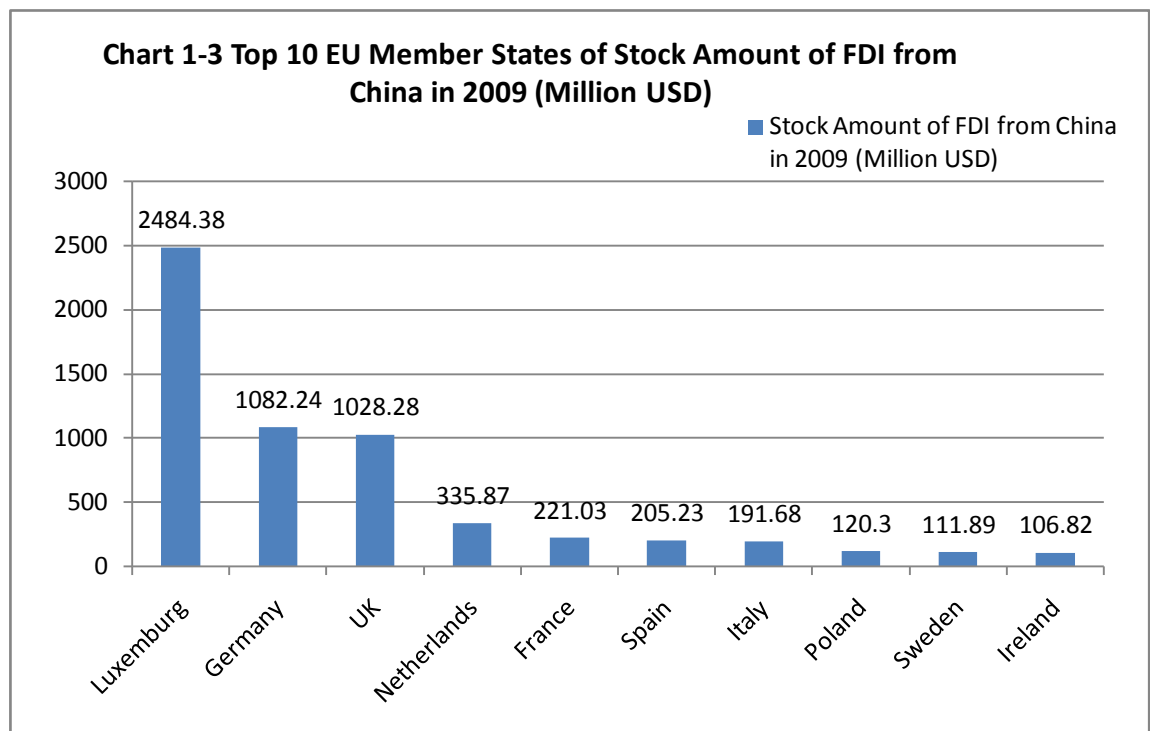
	FDI Flow						FDI Stock					
	2004	2005	2006	2007	2008	2009	2004	2005	2006	2007	2008	2009
<b>China's Total FDI</b>	5.5	12.3	17.6	26.5	55.9	56.5	44.8	57.2	75.0	120.0	184.0	245.8
<b>China's FDI to EU</b>	0.16	0.40	0.60	1.54	0.88	2.97	0.68	1.27	2.27	4.46	5.13	6.28

Source: 2004-2009 Statistical Bulletin of China's Outward Foreign Direct Investment

This paper takes European Union as the study target market for China's FDI operations. Currently EU has 27 member states. The term new EU member states used in this paper refers to countries which joined EU in the EU enlargement in 2004 and after, namely Malta, Cyprus, Estonia, Latvia, Lithuania, Poland, Czech, Slovakia, Slovenia, Hungary, Bulgaria and Romania. The term old EU member states used in this paper refers to countries which are already members of EU before 2004 enlargement, including Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and UK. Statistics of recent years indicates that China's FDI to EU mainly concentrate in European traditional powers, such as Germany, UK and France.



Source: 2009 Statistical Bulletin of China's Outward Foreign Direct Investment



Source: 2009 Statistical Bulletin of China's Outward Foreign Direct Investment

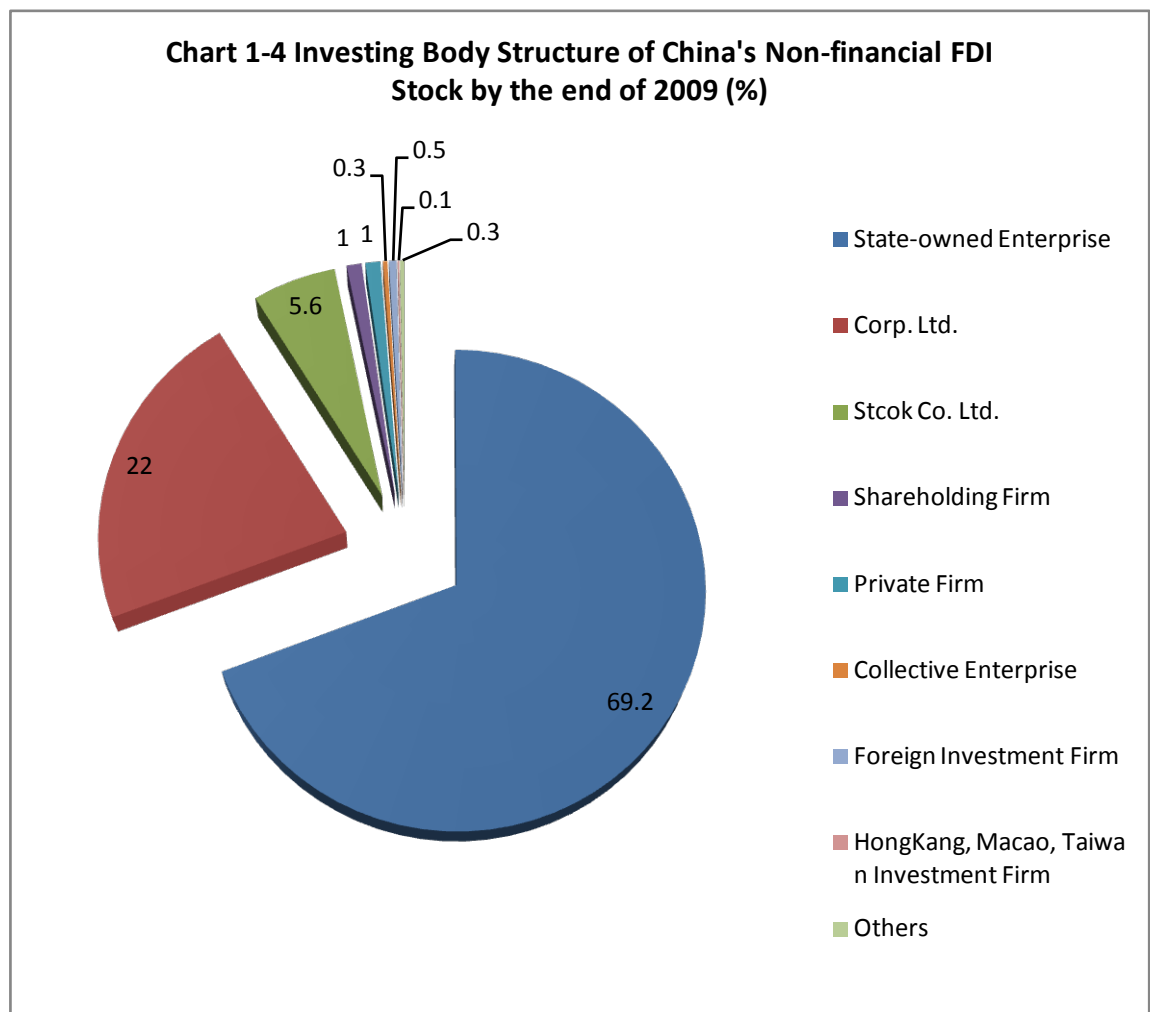
*In 2009, the inflow FDI of Luxembourg reached 88 billion Euros, accounting for 40% of the EU member states total FDI inflow of the year. UK and France follow behind with shares of 15% and 5% respectively. The lion share of Luxembourg owes to its important role as a financial intermediary in international investment transactions.<sup>1</sup>*

From chart 1-2 and 1-3, we could see that China's FDI to Europe still concentrates mainly in traditional European powers. Old EU members account for the majority in both China's FDI flows (9 out of 10) and stocks (9 out of 10) rankings. Moreover, an overlapping part, which consists of seven countries (Luxembourg, UK, Germany, Netherlands, France, Spain, and Italy), can be easily noticed. On the contrary, China's investment toward new EU members still remains at the beginning stage. Although the amount of overall investment in Czech has reached 15 million US dollars, the size of FDI to other new EU members does not see a significant growth. New EU members will sooner or later become a target region of great potential and opportunities for Chinese investors.

From the current statistics, China's FDI in EU has a strong feature of industry concentration but with a trend of becoming diverse. Trade and other commercial service, transportation, and finance are China's three investment focuses in EU. Some investment projects also take place in other industries like mining industry, high-tech industry, and process manufacturing industry. At present, although FDI from China has not been involved in industries with far ranges, those industries mentioned above turned out to be wise choices where advantages of enterprises of both host country and China are closely combined together.

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<sup>1</sup> Source: Eurostat, Statistical Office of the European Commission



Source: 2009 Statistical Bulletin of China's Outward Foreign Direct Investment

About the composition of the investors, as is shown in chart 1-4, we could clearly see that state-owned enterprises are the main body of the investors in the case of China, which accounts for 69.2% of the entire amount of FDI stocks. For instance, in the transportation industry, Chinese state-owned enterprises, like China Ocean Shipping Company (COSCO), China Shipping Company, China National Aviation Holding Company (CNAH) and etc., have not only established branches and wholly owned subsidiaries in Germany, UK, Greece, Italy, Austria and Netherlands, but also begun to seek for opportunities of merger with companies in the host country. If we look at the financial sector, major investors are composed of state-owned commercial banks and

insurance companies. All of the four major Chinese commercial banks (Industrial and Commercial Bank of China, Agricultural Bank of China, China Construction Bank, Bank of China) have investments in EU.

## **1.2 Definition of Chinese state-owned enterprise**

There is no one single definition for Chinese state-owned enterprise. As for the classification of SOEs, ‘state-owned enterprises’ and ‘state-owned and state-holding enterprises’ have been used in official statistics<sup>2</sup>.

The term “state-owned enterprises” refers to business entities established by central and local governments, and whose supervisory officials are from the government. Most importantly, this definition of ‘state-owned enterprises’ includes only wholly state-funded firms<sup>3</sup>.

The term ‘state-owned and state-holding enterprises’, which came into use since the mid-1990s, consists of state-owned enterprises plus state-holding enterprises. State-owned enterprises are, as aforementioned, wholly state-funded firms and the definition of ‘state-holding enterprises’ is that they are firms whose majority shares are held by government. This broad and clear definition of SOEs is used and published by the *China Statistical Yearbook*, includes all state-owned and state-holding companies.

In this paper, the term ‘Chinese state-owned enterprise’ (CSOE) refers to China’s ‘state-owned and state-holding enterprises’. Other forms of expression, like government-owned enterprise, government-controlled enterprise and state enterprise, all

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<sup>2</sup> *State Owned Enterprises in China: Reviewing the Evidence*, OECD Working Group Privatisation and Corporate Governance of State Owned Assets, 26 January 2009

<sup>3</sup> Statistics are majorly distributed by the Chinese Ministry of Finance in publications such as the *Finance Yearbook of China*.

share the same meaning with Chinese state-owned enterprise.

### **1.3 Aim of Research**

This paper attempts to conduct a systematic study on potential FDI entry mode influencing factors from two perspectives: Chinese state-owned enterprises as ordinary firms and as special government enterprises. It aims at building a macro-level framework of FDI entry mode selection for China's state-owned enterprises investing in EU and providing theoretical solutions in optimum entry mode selection for their decision makers. Qualitative approach and SWOT analysis will be employed. The framework would potential benefit decision makers of Chinese state-owned enterprises as it provides insights and suggestions on their choice of optimum FDI entry mode combinations, as well as potential threats these entrepreneurs may be faced with.

In order to achieve the object of the paper, several tasks will need to be accomplished. These tasks are as follows:

1. Review existing literature on FDI entry mode research from both theoretical and empirical perspectives.
2. Analyze theoretical frameworks of entry mode selection study approaches and theories involved. Find theoretical support in help building the framework.
3. Study influencing factors of FDI entry mode selection from theoretical perspective, Chinese state-enterprises as ordinary firms.
4. Investigate special characteristics of Chinese state-owned enterprises and the potential influencing contributors, using SWOT, Chinese state-enterprises as special government-controlled enterprises.
5. Investigate the current feature of entry modes used

6. Integrate all previous findings and build the framework
7. Provide China's state-owned enterprises with appropriate suggestions for choosing the right entry mode in accordance with each of their different investment motivations characteristics.
8. Conduct case studies using the framework

#### **1.4 Significance of Research**

From the intuitional observation and analysis on the statistics above, we could see that FDI of Chinese state-owned enterprises is enjoying a vigorous growth. In China, state-owned enterprises play a crucial role in the economic development. Besides the internal economic activities, this can also be reflected from external investment plans. According to "2008 Statistical Bulletin of China's Outward Foreign Direct Investment", Chinese state-owned enterprises have been holding the largest share in FDI stocks in the recent years. Many of these state-owned enterprises, especially big firms like China Ocean Shipping Company and China National Offshore Oil Corporation (CNOOC), have provided companies of other forms rich overseas investment experience from their former successful FDI activities. Since the state-owned enterprises are a special group which are different from other investing bodies, it will be of much significance if we could study how investment entry mode selection can be made during their decision making progress, how to solve realistic problems in order to maintain competitive on the international level.

At present, compared with the continuously growing total amount of FDI, Chinese investment into EU does not seem to be at a vantage point. But investing in EU is becoming a trend and European markets possess advantages in attracting more and more inflow investment. First of all, EU is one of the regions which hold the world's largest



FDI stocks. The fact of lacking enough investment in this region has already realized by Chinese authorities. In addition, EU is the third biggest trade partner of China. The effect of EU enlargement in the new century can be told not merely from its political power-up, but much more from the expansion of its market volume. Well-functioned investment policies and laws, together with its excellent infrastructure and cultural diversity, will definitely offer Chinese firms convincing reasons for prospective investment chances. Thirdly, the high level of advanced technologies and management strategies from the developed countries in EU would surely catch the attention of Chinese firms which are growing rapidly and in search of methods for further growth. Last but not the least, many EU countries are also looking for cooperation opportunities with Chinese firms. New policies are made in order to bring in more FDI from China. For example, France and China offered each other over 90 overseas investment projects which secured mutual benefits. All these reasons listed above are in support of the assertion that Chinese state-owned enterprises will no doubt continually enlarge their future FDI in EU.

Studies on FDI of Chinese state-owned enterprises in EU, therefore, are of great practical significance. Rational development strategies are prerequisites for the entry of European market. In the study of overseas investment strategies, the choice of entry mode is one that could be decisive to the success of FDI projects. From the investment establishment process aspect, modes of FDI can be categorized as new business investment and cross-border merger and acquisition; from the overseas enterprise stock composition aspect, modes of FDI can be divided into joint venture and wholly foreign-owned enterprise. Different modes of investments differ in resource input, control level, and risk responsibility, and therefore the returns and output are various as well. The mode of investment does not solely affect an enterprise's management strategy and control over its overseas subsidiary, but also its own potential risk and performance through the investment. There are some former cases that stress the

importance of investment mode selection. Due to inappropriate investment mode selected, some investment projects brought in by Chinese firms eventually failed. In all, to ensure the state-owned enterprises could make the right choice at the beginning of their investment, we need to carefully think about the best strategy for investment mode.

This paper takes China's state-owned enterprises as research target and set the main focus, or investment location, on EU member states.

## **1.5 Research Structure**

The research structure is illustrated in Chart 1-5 (See Appendix)

The first chapter raises the research question about Chinese state-owned enterprise FDI to EU entry mode selection and significance of the study. The next chapter will be reviewing existing literature from both European and Chinese sides. Chapter Three mainly discusses FDI entry mode selection related theories. Chapter Four is going to take CSOE as ordinary firms and examine their FDI entry mode influencing factors from two different advantage transfer aspects. Chapter Five mainly deals with the uniqueness of CSOE and employs SWOT analysis in extracting possible influencing elements of entry mode selection, CSOE taken as special government enterprises. In Chapter Six, features of current entry mode pattern will be discussed and then, with reference to previous theoretical preparation, the final framework of FDI entry mode selection will be formed. The latter part of the chapter conducts two case studies in providing further suggestions on choices of FDI entry mode. Chapter Seven concludes.

## CHAPTER TWO: LITERATURE REVIEW

### 2.1 Theoretical foundation of Investment Mode Selection

The theoretical foundation of FDI investment mode selection originates from the development of multinational enterprises (MNEs). Hymer is the pioneer in this field. In 1960s, he <sup>4</sup> (1976) claims that a prerequisite of MNE establishment is the ownership of knowledge and skills, which can be referred to as 'ownership advantage'. As domestic firms of host countries are more likely to be in a superior position of better understanding the local market environment, consumer behaviour, and being more experienced in business, foreign companies will need the ownership of unique expertise to offset their disadvantage of being foreign. Otherwise, MNEs would never be able to compete with their local opponents. Hymer's work has begun to set up a systematic theoretical framework for the theories of multinational enterprises management. After this, Raymond Vernon (1966) introduced Product Life Cycle theory. Buckley and Casson<sup>5</sup> (1976) conceptualized internalization theory. Then followed the contribution of Dunning's <sup>6</sup> (1977; 1981) famous OLI paradigm. In the OLI theory, the entry mode of a multinational corporation is determined by three sets of advantages: O (ownership advantage), L (location advantage), and I (internalization advantage). Ownership advantage refers to multinational enterprises' specific nature advantages, such as human

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<sup>4</sup>Hymer, S., (1976), *The International Operations of National Firms: A Study of Foreign Direct Investment*, MIT Press, Cambridge, MA.

<sup>5</sup>Buckley, P.J., Casson, M., (1976), *The Future of the Multinational Enterprises*. London: Macmillan

<sup>6</sup>Dunning, J., (1977), *Trade, Location of Economic Activity and the multinational enterprise: A Search for an Eclectic Approach*. The International Allocation of Economic Activity, New York: Holms and Meier.

capital, technology and knowhow. Location advantage is arising from strategically investing in different locations. As resources and policies are varied from place to place, MNEs could potentially minimizing production and other costs by choosing wisely to invest in different locations. Internalization advantage arises when multinational enterprises decide to transfer their ownership advantages across countries but within the company. However, through frequent business contacts between multinationals and domestic firms, the technology and expertise owned by multinational companies may not necessarily be transferred to the host country via market business. Later, Kiyoshi Kojima enriched the FDI theories by using a Japanese model of multinational business operations.

In theories of monopolistic advantage and internalization advantage, foreign direct investment is considered as a MNE's mode of entry to overseas market. After Hymer, H. G. Johnson points out reasons why MNEs would internalize knowledge products with 'public' attribute.

Kogut (1988, 1991), Merlin (1992), Liang (1995) and some other scholars used the angle of enterprise strategies in the research of FDI entry mode selection. This theory emphasizes the minimization of production and transactional costs when other conditions and enterprise strategy are held.

## **2.2 Literature Review on Investment Mode Selection**

### **2.2.1 Empirical Studies on Investment Mode Selection**

Based on different theoretical frameworks, researchers of many countries have carried out empirical studies to test the findings and conclusions of theories about FDI entry

mode selection, which diversified the theory of FDI.

On the ownership structure aspect, researchers mainly take enterprise costs, product life cycle of foreign direct investment, and cultural difference as threads of research. The work of Leung <sup>7</sup> (Leung, 1997) shows that the life span of joint ventures is on average shorter than that of wholly owned firm. *'An international joint venture is formed when the partners contribute different benefits to the venture. Each party learns from the others through the joint venture. However, the literature suggests that joint ventures are unstable. So it is hypothesized that, on average, an international joint venture will have a shorter duration than a foreign wholly-owned subsidiary.'* In the long term view, MNEs have comparatively adequate time in adapting the local business environment and accumulating operational experience, which are essential assets in overcoming cultural difference disadvantage. Therefore, transform from partly owned venture to wholly owned firm is considered to be strategic choices in most cases.

Caves and Mehra (1986) take the number of countries involved in MNEs' overseas operation as a measurement for their overseas operational experience, and have arrived at the similar results.

The study of Gomers Cassers <sup>8</sup> (1989) shows that *'MNEs are found to prefer a joint venture with a host-country firm over a wholly owned subsidiary when: (1) the capabilities of the local firm complement those of the MNE; (2) the contributions of both firms are costlier to transfer contractually than through ownership channels, and (3) costs due to shirking by partners and conflicts between them do not outweigh the benefits or joint ownership. (Gomers Cassers, 1989)'*

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<sup>7</sup> Leung, W. F., (1997), *The Duration of International Joint Ventures and Foreign Wholly Owned Subsidiaries*. Applied Economics. (29): 1255-1269.

<sup>8</sup> Casseres, B. G., (1989), *Ownership Structures of Foreign Subsidiaries. Theory and Evidence*. Journal of Economic Behavior and Organization. (11): 1-25.

On the perspective of overseas firm establishment process, important clues are enterprise advantage, characteristics of industry involved, R&D, etc. Anderson and Svensson believe that the unique advantages of a company could bias the preference between M&A and Greenfield investment forms.

Kluas Myer and Saul Estrin analyzed the difference of M&A and Greenfield, based on transactional costs theory.

Stefano Rossi and Paolo F. Volpin conducted a thorough study on laws and regulations of various countries and their influence to M&A investment. According to their observation, larger scales of M&A are more likely to be detected in countries with better functioning accountant and shareholder rights protection system. Findings of studies by Agarwal and Ramaswami, Kim and Huang (1992); Buckley and Casson (1996); Hennart and Reddy (1997) are all in support of the inference that an MNE would employ M&A mode of entry when MNEs become mature in their overall scale. The research on investment behaviour of MNEs of pharmaceutical and electronic appliance industries by Kuemmerle and on motivation of MNEs' R&D centre based in the US by Florida (1997) both indicate that the motives of these institutes' engaging in FDI are mainly to obtain advanced technology from the target market, in order to strengthen their market leadership technologically. *'...the globalization of innovation is driven in large measure by technology factors. Of particular importance is the objective of firms to secure access to scientific and technical human capital. (Florida, 1997)'*

Kuemmerle (1999) based his research on an econometric analysis of 136 laboratory investments and the findings indicate that *'...relative market size and relative strength of a country's science base determine whether FDI in research and development is carried out in order to exploit existing firm-specific advantages, or in order to build up*

*new firm-specific advantages. This holds true in similar form for Japanese, European and U.S. firms and across the two industries. (Kuemmerle, 1999)'*

Especially for MNEs of technology intensive industries like pharmaceutical and telecommunication industries, establishing of overseas R&D centre is a common practice ever since 1990s and will last for a long time.

### **2.2.2 Existing Literature Review on Chinese Firm FDI Entry Mode Selection**

About ownership structure, Lingzhen Yao and Daxie Yang (2003) targeted the efficiency of joint ventures and found that joint ventures are in general faced with a kind of costs that can be understand as loss of efficiency. Since joint ventures are lower in efficiency, they will sooner or later have to decide whether to transform into wholly subsidiaries. Then Yao and Yang analyzed the case of MNEs entering Chinese markets, with a reference to the general practice of MNE market entry decisions. They also presented suggestions for Chinese firms which are going to participate in international investment activities. Guoshun Wang and Dengfang Zheng (2006) employed a time series data set and conducted a study on the importance of factors which influence investment mode of entry selection. The significance of chosen factors' influence is changing various during different stages of the investment process. They tested four hypotheses and gave out suggestions for investors during their decision making process at different time points. *'The main conclusions are as follows. First, the FDI entry mode choice is influenced by the interaction between firm-specific, strategic, environmental and transaction-specific variables. Since different variables suggest different entry modes, it is of critical importance that management decision-makers consider the relative weight of the firm-specific, strategic, environmental and transaction-specific variables when selecting a mode of entry. Second, it is found that asset-specific factors, psychic distance,*

*knowledge tacitness, location risk and FDI policy factors are the primary factors of FDI entry mode choice in China, and the degree of their impact on FDI entry mode choice are on the increase accordingly.*' (Guoshun Wang and Dengfang Zheng, 2006)

Regarding overseas subsidiary establishment modes, Zhanqi Yao proposed a simplified model for enterprises entering international markets. The model mainly deals with the question when and under what conditions an MNE would select Greenfield or M&A investment mode. The paper also discussed policy and regulation issue about FDI. It argues *'argues that the host country government s should balance t he positive effect s and negative effects when it establishes it s policies to regulate the direct investment of multinational enterprises. Finally, it analyzes the foreign direct investment of multinational enterprises that happens in China and put s forward the policy tropism. (Yao, 2006)'*

Langnan Chen, Ruming Hong, Mianbi Xie (2005) carried on the study over FDI entry mode selection with their work 'Entry Methods of Serving Foreign Markets for Chinese MNCs'. They first analyzed advantages and disadvantages of various investment entry modes and summarized foreign countries' former experience of entry mode selection between Greenfield and M&A, wholly owned and partly owned forms, and their influencing factors. Then they applied the findings from their previous analysis to Chinese investing firms who are seeking for international projects and proposed some advices. *'Acquisition and partially owned subsidiaries for know-how oriented FDI in developing countries; newly established subsidiaries and partially owned subsidiaries for product-transfer oriented FDI in developing countries; and partially owned subsidiaries for resource oriented FDI. (Chen, Hong, Xie, 2005)'*

Through a respective differentiation analysis combined with quantitative method and Tobin's Q theory, Xiaohong Li (2006) argued that M&A has gradually become a crucial



way for enterprises to take part in international investment operations.

In the existing literature on studies of entry mode choice influencing factor, apart from the contributing factors introduced by Langnan Chen and his colleagues, some other factors were also raised and tested by Chinese researchers. With a reference to knowledge factor, Yuanxu Li and Ying Zhou (2006) argued that level of tacitness of enterprise knowledge (KM) is an important factor in deciding which FDI mode of entry a firm would use, and knowledge transfer capacity is the decisive factor. Huiming Cai (2006) forwarded the research over FDI entry mode selection factors in the perspective of how to fortify the efficiency of transferring and utilizing firm specific advantages. After reviewing and summarizing theories about foreign direct investment, he drew the conclusion that three factors turn out to have contributing effect in deciding FDI entry mode, including firm specific advantage resource transfer starting point factor, transfer ending point factor and enterprise strategy factor.

In addition, Li Kong (2006) investigated the alternation of FDI entry modes and pointed out the trend of Greenfield substituted by M&A. The focus of the paper basically deals with the question ‘...*why transnational M&A becomes the most way of FDI. With the development of Chinese economy, transnational M&A will become the most way of the FDI. In the text, we find the trend and must take measures to make M&A be helpful to China. (Kong, 2006)*

Ping Deng (2007) used strategic asset-seeking approach and case study evidence in examining the rationale of Chinese companies outward FDI in acquiring natural resources. His work argued that asset-seeking FDI is widely used by Chinese firms in order to gain access to foreign strategic resource reserves in developed countries.

Qiang Wu (2006) studied new FDI entry modes adopted by Chinese firms investing

abroad and further introduced high-tech industrial park as a new method.

### **2.2.3 Literature on Studies of Chinese Investing Firms in EU**

For the reason that Chinese firms' investment in EU does not account for a large proportion in China's entire FDI amount, research and studies about Chinese firms investing in EU seem to be not quite thorough. Tong Lu (2000) examined China owned firms in UK and discussed seven factors of these subsidiaries that influence the internationalization of Chinese state-owned firms, including ownership structure, investment motivation, management strategy, competition advantage, mode of entry, level of management, process of acquiring know-how. Bo Xu (2001) claimed that Chinese firms already have conditions and capability to invest in Western European countries and further proofed the argument by analyzing the motivation of Chinese enterprises investment operations in Europe. Liangwei Zhang (2002) conducted an analysis of investment status of China and EU under the background of their bilateral operation.

## **2.3 Conclusion on Existing Literature Review**

As is shown in the literature review, the development of FDI mode theories are closely linked with economic growth. At the initial stage of foreign direct investment development, most large-scale investing bodies were enterprises from developed countries. They were dominant powers in their industries. So the theory of monopolistic advantage seemed to be quite satisfying in explaining enterprise growth and investment activities. As the world economy developed, however, developing countries got more and more actively involved in investing in foreign countries. Monopolistic advantage

theory could no longer provide sufficient and convincing answers in explaining new investment phenomena and trend. Then the eclectic theory of international production and the theory of transactional cost were introduced. With the rapid pace of globalization in the second half of 20<sup>th</sup> century, outward investment to foreign countries became so important that it is now serving as an economic tool for the whole world's economic accumulation. Thereafter, economists started to pay special attention on the factors that influences the decision making process of FDI. And the mode of foreign direct investment became a field in the studies of FDI. From the early joint venture and wholly owned enterprise forms to new business investment and cross-border merger and acquisition, more and more scholars take in various investment modes in their qualitative and quantitative researches.

But we should also notice that deficiency still exists in the current theoretical framework. If we take a look at the overall development progress of these investment theories, we could see that they are not totally separate but complementary with each other. As these theories themselves are developing and being amended, explanations on the basis of them are coming to fit the real economic practice more than ever. Monopolistic advantage theory, internalization theory and the early eclectic theory of international production all take FDI as a market entry method that is different from the traditional method 'export, permission to do business'. In the following theory of transactional cost, FDI mode of entry comes to be a target for analysis. The issue of overseas subsidiary ownership is also an important part that is addressed in the theory. But the theories mentioned above seem to deal with only wholly owned enterprises. The question how to effectively select FDI mode of entry remains untouched. Based on present theories, this paper will attempt to analyze mainly on entry modes of Greenfield, M&A, wholly owned and joint venture.

## **CHAPTER THREE: FOREIGN DIRECT INVESTMENT ENTRY MODE THEORIES**

Entry mode is the reflection of a firm's preference over its asset and risk control, and level of integration during the international expansion process. In order to more precisely grasp factors influencing entry mode selection and impacts to enterprises, we will need to conduct comparison studies of characteristics of different entry modes. Over the recent 30 years, the question how to make appropriate choices over entry mode has been an issue that is under attention and debate. Several theoretical frameworks and analyzing approaches are employed by economists over the world. This chapter will first review the classical theories related to FDI entry mode study and then conduct a comparison analysis between major forms of investment entry modes, Greenfield and M&A, wholly-owned firm and joint venture.

### **3.1 Review of Foreign Direct Investment Entry Mode Related Theories**

Theories of FDI entry mode selection are mainly developed in three different approaches.

The first approach is Market Imperfection and Market Failure paradigm raised during 1960s and 1970s. Key theories of it are Transactional Cost theory, Internalization theory, and Eclectic theory. Main contributors of this theory are Backley and Casson (1976,

1998), Anderson and Catignon (1986), Dunning (1988, 2000), Kim and Hwang (1992).

Researchers also take Behavioural paradigm as another approach in the study of FDI entry mode selection. In this approach, Internationalization is one of the most important theories. Johanson and Wiedersheim (1975, 1993), Johanson and Vahlne (1977, 1990) are representatives among scholars in this field.

The Resource-based View (RBV) paradigm as the third approach becomes widely accepted during 1990s. The three major theories involved in this approach are Resource-based Firm theory, Core Competency theory, Dynamic Capability theory, which are together known as Organization Capability theory. Representative researchers in this field are Wernerfelt (1984), Kogut and Singh (1988), Perteraf (1993), Madhok (1997, 2002), Teece. et al.(1997).

Theories of these three approaches offer explanations to the behaviour and mechanism of foreign market entry mode selection from cost, efficiency and process dimensions respectively, and provide fruitful research findings. The following will be a brief review and comment on the representative theories of these three approaches.

### **3.1.1 Transactional Cost Theory and Internalization Theory**

Transactional Cost theory and Internalization theory both argue that when transferring peculiar or exclusively owned knowledge and technology abroad, enterprises are able to lower transactional costs by utilizing their internal organization structure and information network rather than the external market.

“In economics and related disciplines, a transaction cost is a cost incurred in making an

economic exchange”. The idea of Transactional Cost theory was first introduced in Coase’ paper ‘The Nature of the Firm’ in 1937, and later advanced by Williamson, Backley and Casson etc. In Williamson’s work, he discussed the essence, origin, development of modern enterprises and corporate structure. Transactional Cost theory holds that choice of entry mode is actually a choice of management structure or level of control, and the optimum entry mode should arise from the trade-off between production costs and returns. Although higher level of control are helpful in reducing agents’ opportunism, it asks for more resource input and higher risk responsibility at the same time; on the contrary, under lower level of control, parent companies are exposed to lower level of input requirement and risk, but agents’ opportunism cannot be overcome. According to the theory of transactional cost, a company should consider the cost incurred during a transaction before it is done. Generally laws of the host country, familiarity with the host country, and cultural difference may all potentially influence entry mode selection through transaction costs. Internalization theory has similarities with Transactional Cost theory in its argumentation.

This theory well explains questions aroused during organization management process of firms as contract entities and the economic mechanism behind it. Being the logic starting point of Internalization theory, it also clearly illustrates the reason why many MNEs choose internalization as the organizational structure during their overseas expansion process. But in the recent years, some scholars claim that using Transactional Cost theory in the study of entry mode has its shortcomings:

1. Transactional Cost theory treats transaction as an independent analysis unit and, therefore, is static. It has ignored the dynamic examination of knowledge creation and transfer efficiency intra- and inter-organizations.
2. The minimum of transaction costs may not necessarily brings the outcome of higher returns or maximum of competitive advantages. The fundamental goal of enterprises as production entities is to maximize enterprise value.

3. It could not provide solid explanations, as it did to internalization, towards the mechanism of joint ventures.

### **3.1.2 Eclectic Theory**

Eclectic theory basically holds that the success of foreign direct investment is not only decided by the presence of enterprises' expertise knowledge and technology, but also the presence of infrastructure in the host country, with which MNEs are able to make their specialized knowledge applicable. And it is internalization capability of the enterprise that further decides whether both expertise and infrastructure conditions could be met.

Eclectic theory is developed on the basis of John Dunning's (1977; 1981) OLI paradigm. In the OLI theory, the entry mode of a multinational corporation is determined by a set of three advantages: O (ownership advantage), L (location advantage), and I (internalization advantage). Ownership advantage refers to multinational enterprises' specific nature advantages, such as human capital, technology and knowhow. Location advantage is arising from strategically investing in different locations. As resources and policies are varied from place to place, MNEs could potentially minimize production and other costs by choosing wisely to invest in different locations. Internalization advantage arises when multinational enterprises decide to transfer their ownership advantages across countries but within the company. It emphasizes comprehensive analysis when studying entry mode selection as the final decision of entry mode derives from multiple influencing factors. These factors mainly include knowledge and knowhow of an enterprise, policies and infrastructure of the host country, value of the transferrable knowledge and the company's transfer capability, cultural difference, etc.

Kim and Hwang (1992) take firms' strategic construct as an endogenous variable into

the framework of eclectic theory. Three underlying constructs are found to be influential to the selection of entry mode: global concentration, global synergy, and global strategic motivation.

There are two major differences between Dunning's and Kim and Hwang's theories.

1. Kim and Hwang focus on single industry while Dunning attempts to explain the reasons for all MNEs going into overseas investment behaviour.
2. Kim and Hwang assume that firm's competitive advantages are temporary; but in Dunning's theory, firm's competitive advantages are monopolistic.

But neither of the two gives clear attention to firm's resource allocation and capability build-up process.

### **3.1.3 Internationalization Theory**

Internationalization (Strategy) theory is introduced and brought forward by some Swedish and Danish scholars. One of its exponentials is Leif Melin (Melin, 1992). Internationalization theory believes that in overseas expansion process, MNEs will be inevitably exposed to challenges from cultural, political, and market mechanism aspects. The essence of going investing abroad lies in its significance of being a part of market strategy and competition strategy. The purpose of foreign direct investment is to diversify risks, promote enterprise reputation, and coordinate company strategies. It could be regarded as a way of strategic defence in order not to let the competition position weakened, rather than ways of merely achieving profits or gaining access to special resources. To avoid risks from these aspects, MNEs are very likely to use progressive strategy in entering the target market.

Internationalization theory takes entry mode selection as a strategy process study. It



reveals the importance of accumulated overseas management experience and knowledge during entry mode choice decision making process. As the accumulation of experience and knowledge deepen, entry mode of larger scale resource commitment, control and risk level will be gradually instead of lower level of market entry. After the early exporting business mode, enterprises would gain easier access to technology permission, and eventually establish wholly owned or form partly owned subsidiary firms in the host country.

But Internationalization theory, unlike the later introduced Organization Capability theory which emphasizes firm internal issues of resource and capability structure, stresses a lot on external influencing factors of the firm, or in other words, the psychological distance between the parent country and the host country. It mainly deals with uncertainty and risks caused by foreign unfamiliarity (Johanson and Vahlne, 2001). In spite of its shortcomings, Internationalization theory still provides us with good reference when studying entry mode and its time-related process characteristics.

#### **3.1.4 Organization Capability Theory**

Organization Capability theory is a theory about forming, maintaining and reinforcing enterprise competition advantages. It mainly includes three major theories: Resource-based Firm theory, Core Competency theory, and Dynamic Capability theory. According to Organization Capability theory, the aim of entry mode selection strategies should be seeking for a combination of appropriate entry mode and the company's long-term development objective, rather than merely minimizing short-term costs. MNEs keep updating improving their capability structure through selecting a series of endogenous entry modes, and further obtain a comparatively stable organizational operational mode in order to maintain adjust production and management procedure and

achieve higher efficiency. Collaborating with other firms, though maybe exposed to higher costs, could broaden firms' vision and enhance their overall capability and bestow them with huge competition advantages and returns.

Under Organization Capability theory, parameters that may influence choice of entry mode are: knowledge transfer experience, managerial skills, international capability, social distance, resource commonality (Madhok, 1998).

The focus of Organization Capability theory lies in enterprises' internal resource allocation mode, organizational structure, and knowledge stimulus effect on obtaining firm growth and market competition advantage. Unlike static Transactional Cost theory, it supports the argument that the choice of entry mode should be in accordance with companies' long-term strategic needs rather than short-term costs and returns. Selection of entry mode is decided by not only Transaction Cost theory and Eclectic theory, but also firms' internal characteristics of resource and capability.

### **3.2 Comparative Analysis of Major Foreign Direct Investment Entry Modes**

There are basically two major questions that need to be answered before a company going to invest in foreign countries: How and in what form of investment and ownership mode the new company shall be established. In other words, the board of the company need to make decisions on:

1. choice of investment mode: whether to create a new venture (Greenfield Investment) or merge/acquire a foreign company (Merger and Acquisition)
2. choice of ownership mode: who would be the new venture's owner(s), partly owned

venture (joint venture) or wholly owned subsidiary.

Therefore, in general, a candidate result of FDI entry mode selection should be a combination of the final decision of investment and ownership modes. This means that an FDI mode should fall into one of the following four types: partly owned Greenfield investment, wholly owned Greenfield investment, partly owned merger and acquisition, or wholly owned merger and acquisition.<sup>9</sup>

The selection of foreign direct investment mode is one of the most pivotal decisions that are going to be made during the process of investing abroad. Appropriate mode of FDI must be based on thorough observation and analysis of the host country's resource stock capacity, economic situation, investment policyfriendiness and other conditions. The results of the analysis, combined with proper investment motivation, would eventually form the mode of FDI the company would use to enter the target market. Wise choice of FDI entry mode marks the key to the success of an overseas investment operation and will maximize returns from the investment. Each mode has its own applicable range and merit. When a company is making decisions on the choice of FDI entry mode, a large set of factors or variables (motivation, target market qualifications, parent company's investment capabilities, international finance market situation, etc.) would be taken into account.

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<sup>9</sup> Other minor FDI modes of entry like Brownfield will not be discussed in the paper.

### **3.2.1 Comparative Analysis of Greenfield and M&A Investment**

#### **Greenfield**

“A Greenfield Investment is the investment in a manufacturing, office, or other physical company-related structure or group of structures in an area where no previous facilities exist”<sup>10</sup>. The parent company usually creates a brand new subsidiary and holds its ownership. Greenfield investment is one of the traditional forms of investment and used to be taken by most MNEs during 1980s. In the recent years, as the M&A form of investment is gaining popularity, the amount of Greenfield investment in international FDI has reduced. But it remains one of the most practical investment mode.

#### **M&A**

“Merger and Acquisition (M&A) refers to the aspect of corporate strategy, corporate finance and management dealing with the buying, selling and combining of different companies that can aid, finance, or help a growing company in a given industry grow rapidly without having to create another business entity”<sup>11</sup>. It is straightforward that Cross-Border Merger and Acquisition has two forms: Cross-Border Merger and Cross Border Acquisition. When cross-border merger takes place, the assets and management of two different companies in different countries combine together and form a new company. In cross-border acquisition, the acquiree company’s control of its asset and management shift to another foreign business entity, while the corporation legal representative of the acquiring company (acquirer company) remains the same. Generally, the two words merger and acquisition can be used together as it is quite

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<sup>10</sup> Broadcom. "802.11n: Next-Generation Wireless LAN Technology White Paper"

<sup>11</sup> Wikipedia: [http://en.wikipedia.org/wiki/Mergers\\_and\\_acquisitions](http://en.wikipedia.org/wiki/Mergers_and_acquisitions)

common that cross-border acquisition takes place during merger activities.

As a kind of complicated business operation behaviour, according to the industry relationship between the acquirer and acquiree companies, Merger and Acquisition could also be divided into three categories: horizontal integration, vertical integration and diversified conglomerate integration.

### **(1) Horizontal Integration**

Horizontal integration refers to the merger or acquisition between two companies which produce or sell similar products or alternatives. The aim of horizontal integration seeks for collaborative effect. With the two companies joining together, asset of the new company will become the add-up of the two companies. Thus, the stronger power enables the company to have more chances of being monopoly and enhances its competitiveness in the international market in order to gain a larger market share. Besides, companies choose horizontal integration type for merger do not have to face a high risk. It is easier for the two merging companies, which have much in common in their products, business operations, and scales, to come to agreement for merger and acquisition. Horizontal integration is more likely to bring in economies of scale effect and internalization. This will further result in an increase in profits. Typical sectors where horizontal integration takes places in are pharmacy industry, automobile industry, petroleum industry, and part of service sector.

### **(2) Vertical Integration**

Vertical integration incurs when a company is merging, acquiring or being acquired

with/by an upstream or downstream company. Vertical integration usually strengthens a company's production and sales ability by occupying related channels along the production or sales stream. It could effectively reduce uncertainty of upstream and downstream collaboration and lower transactional costs. At the same time it expands the source of raw materials for production and distribution channels for products. Because the two merging companies are in the same line (but different stages) for producing the same goods, they are familiar with each other's business. New firms established from vertical integration usually turn out to be stable and functioning well with internal collaboration. Good examples are parts makers and their clients, such as electronic products assemblers and automobile producers.

### **(3) Diversified Conglomerate Integration**

Diversified conglomerate integration is the combination of horizontal and vertical integration with at least two different companies. The goal of diversified conglomerate merger is to minimize investment risks and deepen economies of scale effect. The idea of diversified investment is often adopted by MNEs as a strategy for international expansion. As it possesses the advantages of both horizontal and vertical integration, the company using this strategy would have much more control power in competing with its opponents. Compared with the previous two investment strategies, a feature of diversified conglomerate integration is that it is sometimes covert and hard to be noticed.

### **Comparison of Greenfield and M&A Investment**

Besides the different way of forming a new venture or subsidiary, Cross-border

Greenfield and Merger and Acquisition also have dissimilarities in the investment process, costs and returns, and the influence to the host country, as is shown in **Table 3-1** in **Appendix**.

### **(1) Investment Process**

#### **1. Investment Target Industry Selection**

It is straightforward to understand that Greenfield investment has the largest range for application. It is applicable to nearly all industries. Theoretically, M&A may also happen in all the industries. But in reality, M&A takes place mainly in industries which have capital and technology concentration and high entry and exit barriers. In these industries, investors would have quick benefits from M&A. By engaging in M&A, they could weaken or remove competitors immediately. Huge amount of research and development fund could be equally distributed or supplied by several partner ventures together. Economies of scale effect would more easily to come to real in purchase, production and sales stages. The reason for this is that by merging or acquiring another company in the target market, the parent company could take quick reactions toward operations of their opponents or potential competitors. For instance, lifting entry or exit barrier of a specific industry, which can be obtained from M&A, is an effective way to limit competitive operations.

#### **2. Investment Cycle**

Greenfield investment cycle mainly includes project feasibility study stage, project evaluation and decision making stage, project construction stage and test run stage.

Normally, creating a Greenfield venture, from potential market investigation to test run and officially operation, requires one to two years. Production in certain scale could be reached after three to four years from the beginning. Basically, Merger and Acquisition cycle consists of research and evaluation of target company, negotiation and contract signing stage, integration period. After M&A, existing resources of the acquire company could be immediately redistributed and utilized including management scheme, technology, human capital, facilities and distribution channels and clients. The whole process may take only several months. Even if the target merging company is in need of reform or restructure, it is very likely to be done within no more than one or two years. Therefore, in the aspect of investment cycle and its timeliness of having operation started, Greenfield investment requires more time to enter the market and gain profit. M&A could be much more quickly (generally two years less) to take effect, and thus may win quick response to market for investors.

### 3. Financing Structure

Greenfield investment aims to create additional power of production. In Greenfield investment, consequently, in spite of material and some intangible input, the investor will usually need to inject large amount of liquid to buy machines and other permanent assets and ensure the construction of the new project. The financing structure of M&A is much more flexible. There are several ways of financing M&A, for instance: assumption of debt, buyout, stock exchange, stock holdings operational method. Financing solutions can be achieved either by cash or stock. A popular strategy of M&A is to acquire certain amount of stock shares of the target company. M&A happens when this amount has reached a given bound.



#### 4. Risk Control

Greenfield investment has fewer limits from the external factors. Its investors are regularly involved in the actual operation of projects, and own better control of risks to a large degree. In the contrary, due to asymmetric information and external limits factors, the rule of M&A can be influenced and prospective returns may face great uncertainty, which is to say M&A investment is more risky than Greenfield. Risks of M&A can be reflected from the following four aspects:

A. the actual amount of funding may be blurry if the evaluation agency is not capable enough to work out a precise evaluation report or does not offer the true results due to a lack of moral constraints. The parent company may further this situation if it does not have an accurate grasp of the target company details.

B. Difficulties and divergences may incur after integration. There are possibilities that the two companies are not consistent regarding new policies about power allocation, interest allocation, development strategy, management scheme, cultural background, etc.

C. If the stock exchange method is in use during M&A, interests of old stock holders may be weakened. When the ownership of the newly issued stocks shift, former stockholders (of the acquire company) will have to face a loss of control power over the company.

D. The existing contracts and old business relationships may become hampers in the way of integration. If the target company leaves behind problems like personnel reallocation, arrears of payment and welfare benefit, arrears of taxes and fee for land transfer, which are not very likely to be solved independently within a short period,

enthusiasm for investment of the parent's company could be negatively affected.

## 5. Investment Environment of the Host Country

Greenfield form of investment enables the investing company to operate under its own development strategies in accordance with its scale of production and location investment plans. As long as policies of the host country allow, investors will try to take in as much as investment activities under their own control. So limits from outside cannot present a strong impact on the running of the Greenfield investment. Different from Greenfield, M&A relies external environment a lot. The most distinct fact is that in the market of the host country, firms, which are consistent to the aim of investors and can potentially become a merging target, must exist. Furthermore, to make M&A happen, investing firms will need stock market to complete M&A. Otherwise, parent companies will do it through negotiations resulting in agreement. The negotiating ability of the target company and interests of other intermediates may compose great impacts to the final investment decision as well. As for cross-border M&A, many international economic policies and law issues may also be involved. In all, M&A is a kind of complex business operation behaviours.

### **(2) Costs and Returns**

#### 1. Costs

Cross-border M&A has comparatively more advantages regarding operational costs. Reasons are as follows: In essence, M&A is a kind of business operation behaviours which aims to internalize all the resources of the target company. Compared with

Greenfield investment which originates from internal accumulation of the host company, M&A has lower costs in obtaining the existing long-term allocation and collaborative operation of human power, financial assets, materials and production, distribution, sales channels. Especially when the target company is on the edge of bankruptcy, costs of M&A is usually lower than that of replacement, and therefore much more cheaper than Greenfield investment. Even if the target company demonstrates well functioned business situation, and the buying costs is higher than that of Greenfield, the prospective returns and optimistic potentials of the target venture will no doubt shorten the period of recovering investing costs, which means that M&A still has comparatively lower costs in this assumption.

## 2. Returns

In comparison with Greenfield investment, M&A are in general expecting more returns.

A. Greenfield investment is just a unilateral shift of ownership advantage, while M&A is a combination of more than two companies. Well matching target company could be complementary to the host enterprise and vice versa. Collaborative advantage will surely lead to larger amount of returns.

B. M&A saves a lot time in the market entry process for the parent company. Thus it bestows the company the advantage of timely grasping business opportunities. As a business expansion strategy, M&A allows the investing company to 'eat up' its competitors quickly. Both advantages could further stabilize the host company's competitive position in the market and secure its market share.

C. Acquiring an entire company means a lot more than the assets itself. It saves costs in

personnel vocational training, market exploration, R&D, brand establishment. This can be known as an indirect investment effect.

D. Through M&A, enterprises could reach economies of scale effect within a short time. When an upstream or downstream company become merged or acquired by the investor, production and distribution are internalized and transactional costs can be reduced.

### 3. Time Factor in Acquiring Strategic Resource

Strategic resource refers to assets and resources that are of strategic significance for long-term development of enterprises. It mainly includes R&D ability, brand awareness, reputation, concession, and distributional network. Strategic resource is the most crucial assets and ownership advantage of enterprises. But they are hard to obtain in external markets. If Greenfield is applied in an investment project, the parent company will have to and could only use its own strategic resources which origin from internal accumulation. The accumulation process usually takes years. M&A, however, could well offset this disadvantage by acquiring another economic entity alongside with its strategic resources, namely, advanced patents, expertise and know-how, brand and trademark, mode of production and management, and distribution network and so on. The whole process of M&A, as is mentioned previously, takes much less time. All in all, M&A is in an ascendant position against Greenfield if we are considering time factor.

### **(3) Influence to the Host Country**

#### **1. Macro-Economic Influence**

If other conditions hold, Greenfield investment could not only bring a large amount of resources to the target market, it also creates additional production power and to a certain degree alleviates local unemployment pressure. Therefore, Greenfield is universally welcome by most local governments and other social members. But Greenfield may not always be helpful to the improvement and restructure of production power and capital stock in the target market. Greenfield investment without accurate market research and plans may even become overlapping with similar projects or absolutely redundant, which cannot provide extra benefit for the market at all. M&A just shifts the ownership of the target company from investors inside the target region outward to investors outside. No additional production power will come into being. Layoffs and market monopoly by the outside enterprises may even incur. As a result, some merger and acquisition projects cannot gain support from local governments. This does not mean that M&A does not have a positive side to the local macro-economy. It could activate some stock capital that is freezed in the market. If the operation goes smoothly, more investment projects may follow up.

#### **2. Micro-Economic Influence**

The number of firms in an industry is a factor that causes great impact to market share and market control distribution. If the number of firms in sector of a certain market holds, Greenfield investment will lead to one more extra company joining the market competition. This is very likely to raise the competition stress between old market share holders and new comers. If M&A is taken as the investing entry mode, number of firms

in that industry remains the same, which is to say that M&A does not involve in the market share redistribution. While not pushing the opponents into higher level of competition and interest conflict, the integration of merging companies may combine advantages from multilateral sides and eventually establish a stable and competitive place in the target market.

### **3.2.2 Comparative Analysis of Wholly-Owned Firms and Joint Ventures**

According to the different ownership structure, the overseas subsidiary, which is established through Greenfield or acquired by M&A, can be divided into two kinds: wholly owned or joint venture (partly owned).

#### **Wholly-owned Investment Mode**

(Cross-border) Wholly owned investment mode means that under laws and regulations of the host country, the parent company provide funding only by itself to create a new subsidiary or acquire all of its stocks in order to gain full control over the target company. Eventually, the company in the target market operates in accordance with the investor's production and management instructions.

#### **Joint Venture Mode**

(Cross-border) Joint Venture mode always involves multilateral parties in the investment process. The investing MNE or investors from other countries, under the permission of government of target market and legal procedure, join together into a

business entity and engage in production and management operations. Apart from initial investment, involvers will also share the same development and management scheme, profit and loss, and risks. Joint ventures can be further categorized according to the different functions: materials and parts supply type, research and development type, market sales and distribution type, aim of obtaining foreign products and technology type, aim of entering new industry type. No matter which type of joint ventures is adopted, they all act under the long-term strategic development plan of the parent firms. The purpose of joint venture can be reflected from enterprises' wish to share and combine their advantages in order to achieve mutual benefit.

### **Comparison of Wholly-owned Firms and Joint Ventures**

Wholly owned investment and joint ventures have clear distinctions in the several aspects, namely control power, investment size, risks, investor size, market reaction flexibility, level of classification, influence from the host country, as is shown in **Table 3-2** in **Appendix**.

#### **1. Control Power**

Wholly owned investment mode allows the parent company to have full control over operation and management. In joint venture mode, due to participation of investors from the host or other countries, all participants are involved in the operation. Control power of each party differs.

## 2. Size of Investment

While wholly owned investment mode requires a large sum of funding, joint venture allows investing partners to bear the investment funding together. Thus it is common that for a single company, the input for wholly owned investment is much more than joint venture method when dealing with the same foreign target project.

## 3. Risks

Since wholly owned investment is fully supplied only by the parent company, it will need to take all the responsibilities for any consequence. Therefore, wholly owned investment mode exposes its investor to very high risks. As for joint ventures, participating investors agree to share loss as well as profits. This is a good way to diversify risks.

## 4. Investor Size

Generally speaking, for large MNEs, they do not necessarily need other investment partners. They are able to afford the financing for wholly owned investment. This kind of investment also rewards them with precious ownership and commercial classification advantages.

For small and medium enterprises, they would prefer to diversify risks by choosing joint venture mode of entry for their FDI. As joint venture mode is very welcome by local governments, it is easier for SMEs to gain support from the host country and access to more strategic resources.



## 5. Market Reaction Flexibility

Because wholly owned firms have the advantage of making quick decisions without inquiring and negotiating with third parties, they are more likely to demonstrate fast reaction to any change in the market.

In comparison, partly owned investment form may not always lead to consensus over the specific or long-term development plans and strategies. Conflicts would take place especially when issues like unequal interest distribution and personnel appointment cannot be well addressed. Internal conflicts may lower workers' working enthusiasm and productivity, and could even lead to disintegration. In all, divergences of cultural backgrounds, development strategies and long-term goals will all present joint ventures negative impacts on market reaction flexibility.

## 6. Level of Classification

Wholly owned enterprises could protect their trade secrets effectively. But for those firms owning advanced technology, going into joint venture means that they will have to deal with possibilities of classified secrets exposure.

## 7. Influence from the Host Country

More often than not, host countries would impose special regulations to wholly owned firms, which limit their business operations with local enterprises. As the policies can be

decisive sometimes, wholly owned investment mode may not be in a position of widely support from local government and the public. With joint venture mode, the parent companies will find it easier to improve their co-operational relationship with the public of the host country. It gives MNEs an incomparable advantage of quick market entry possibility and discriminations and unfairness can be avoided.

### **3.3 Conclusion of Chapter**

In Chapter Three, this paper mainly discusses about study approaches and theories which offer investment entry mode selection strategies. Three classic approaches of entry mode research are briefly presented at the beginning of this chapter, namely Market Imperfection and Market Failure paradigm, Behavioural paradigm, and Resource-based View paradigm. On the basis of the three analysis approaches, theories of Transactional Cost and Internalization, Eclectic theory, Internationalization theory, and Organization Capability theory are reviewed and commented in the first section of this chapter. The second part employs comparison analysis method to study major forms of FDI entry modes: Greenfield and M&A, wholly owned firm and joint venture, from different aspects.

## **CHAPTER FOUR: THEORETICAL ANALYSIS OF CHINESE STATE-OWNED ENTERPRISES IN EU FDI ENTRY MODE INFLUENCING FACTORS: CSOES AS ORDINARY COMPANIES**

Chapter Four will be an analysis of possible FDI entry mode selection factors for Chinese government-owned enterprises investing in EU. In this chapter, the paper will take Chinese state-owned enterprises as ordinary companies, and thus we are able to apply the earlier discussed FDI theories to these state enterprises and examine the entry mode factors in a general sense.

From the colligation of the theoretical introduction in Chapter 2 and Chapter 3, we now have a list of theories that could possibly affect selection of FDI entry mode.

**Table 4-1 FDI Entry Mode Selection Related Theories and Elements that might potentially influence Entry Mode**

<i>FDI Entry Mode Related Theories</i>		<i>Theoretical Focus and Elements that Might Potentially Influence Entry Mode</i>
Theories Directly Related to FDI Entry Mode	Transactional Cost theory and Internalization theory	Transferrable advantage character, transfer capability
	Eclectic theory	Transferrable advantage character and value, transfer capability, host country environment
	Internationalization (Strategy) theory	Tactics about advantage transfer and adjustment to host country
	Organization Capability theory	Reinforcement of company advantage
Other Theories Indirectly Related to FDI Entry Mode	Monopolistic Advantage theory	Transferrable advantage character, host country policy
	Product Life Cycle theory	Host country infrastructure, Cultural difference

According to the elaboration of FDI entry mode selection related theories and the **Table 4-1**, we could make a brief summary that:

- A. All the theories have adopted ‘advantage transfer’ approach in explaining FDI phenomena;
- B. Every single of the FDI entry mode influencing factors mentioned in the these theories is connected with either MNE or host country.

If we take MNE as the start point of FDI and host country as the end, it seems very logic that we could divide all the influencing factors into two groups: advantage transfer start point factors and advantage transfer end factors. As other ordinary investing MNEs,

FDI entry mode selection of Chinese state-owned enterprises would be affected by these two types of factors as well. Specifically, candidate factors are listed as follows.

Advantage transfer start point factors (internal factors) refer to factors from the MNE side, including:

1. Enterprise product and service factor
2. Motivation
3. Developing strategy
4. Company performance
5. Investment experience in the host country

Advantage transfer end factors (external factors) are influencing factors on the host country's side, including:

1. EU investment related laws, policies and regulations
2. Level of Economic Development and Marketization
3. Quality of Infrastructure in EU
4. Social and Cultural Background of Europe
5. Local Partner
6. Influencing Factors from Inside China

#### **4.1 FDI Entry Mode Factors Study: Advantage Transfer Start Point Factors**

##### **1. Enterprise Product and Service Factor**

Enterprise product and service is a direct and intuitional reflection of the company's knowledge and technology advantage. The influence of enterprises' product and service on the choice of investment entry mode can be reflected from several aspects, including product and service differentiation and product technology. The more different a company's products and services are from those of other firms, the more advantages it will have, and the more likely that the company will choose wholly owned investment mode. Products, which contains high technology and has a life cycle, also known as technology concentrated products would normally contribute to the selection of wholly owned mode or make the company become the major share holder in a joint venture, in order to project the ownership of the technology. If a company owns the technology and monopoly over the logo, patent, and core knowledge of a product which could quickly adapt local market, its owner may want to use Greenfield then. Chinese products are well known for cheap prices, and also low value-added elements. This is still the fact with most Chinese firms in general. But in order to add more technology into products and acquire core technology and brand effect, China's government-owned enterprises are starting to think more about acquiring European big brand companies. Examples are M&A cases of Chinese government-owned electric appliance enterprise TCL with French Thomson Electrics Corporation in 2004, and Nanjing Automobile Corporation (NAC) with UK MG-Rover in 2005. In European market, there are state-owned enterprises from China with high-tech products as well. At present, Chinese state-owned aerospace firms' investment in EU contains world leading technology and the investors should, therefore, pay much attention in the protection of its commercial knowledge and secrets when deciding which FDI entry mode should be in use.

## 2. Motivation of Investing in EU

Generally, the motivation of Chinese state-owned enterprises' investing in EU is to seek for natural resources, technology, potential markets, distribution channels, or management experience. Different investment motivations will on a large degree decide procedure of investing operation, and thus lead to different choices of FDI entry modes. We may use examples to illustrate this point. For investing enterprises which are after foreign high technology and distribution channels in EU, M&A will present them a shortcut in achieving their long-term goal; as for enterprises looking for long-term target market or trade barrier evading, no matter wholly-owned form or joint venture entry mode used, Greenfield is always a good choice.

## 3. Enterprise Developing Strategy

A majority of Chinese state-owned enterprises investing in EU are large-scale firms which have clear developing strategies. Their developing strategies will no doubt impose an impact on their decision of FDI entry mode selection. In the early time of Chinese financial enterprises investing in EU, Chinese central bank and the four major commercial banks all opened wholly owned representative offices in London. Their aims are mainly set as market information collection. Basically, developing strategies used by state-owned enterprises investing in EU include enterprise strategic upgrade, reform or globalization deploy. Investment mode combined with globalization deploy developing strategy can be very flexible. If enterprises desire business upgrades or internal reform or transformation, they are more likely to use M&A mode in their overseas investment. Normally, most Chinese state-owned enterprises have a systematic

and strict requirement in the development of their foreign subsidiaries. In order to make sure foreign branches are functioning in consistency with the developing strategy of the global headquarter, parent companies will need to be the major share holder of their subsidiaries.

#### 4. Enterprise Performance

The business performance, financial status, and profitability capability of the parent company could also influence its FDI entry mode. A well functioning and profitable company with sufficient liquidity supply could face lower risks when operating in foreign countries. As a consequence, they would like to be wholly owned investors. But this does not deny their going into M&A as M&A will be a reliable method in diversifying risks. Enterprises of excellent credit standing would also favour Greenfield investment as they have strong financial backup.

#### 5. Investment Experience in the Host Country

Former experience of investing in the host country plays a very important role in Chinese state-owned enterprises FDI mode selection. As is discussed earlier, in general, enterprises without enough investment experience in the target market will prefer to choose M&A method to enter. By doing this, they could not only obtain strategic resources from the merged local companies, but also instant business local operation experience and adapt themselves into the target market. It also seems straightforward that Chinese government enterprises with insufficient EU investment experience would favour partially-owned entry as the collaboration mechanism could off-trade their unfamiliarity with local market.



## **4.2 FDI Entry Mode Factors Study: Advantage Transfer End Point Factors**

Advantage transfer end point factors are not located on MNEs' side, which means in this paper that they are not controlled by China's state-owned enterprise. There are mainly two types of external factors: influencing factors from EU side and factors from inside China.

### **4.2.1 Advantage Transfer End Point Factors from EU Side**

#### **1. EU Investment Related Laws, Policies and Regulations**

Investment activities in EU must obey European and the host country's laws and policies. These legal bindings and restrictions provide a framework in which foreign investment projects could be operated. Factors of FDI related laws, policies and regulations cannot be controlled or changed by investing firms. Laws of European members set bound for foreign stock holders in M&A mode of investment as well as standards and common practice of ownership transfer, foreign exchange management, customs and taxations, profit repatriation, etc. For some highly sensitive industries and high return rate and low risk monopolistic industries, local governments would even introduce related laws in order to limit foreign investors' participation. All of these may influence foreign firms' decision on FDI entry mode. Due to the uniqueness of Chinese state-owned enterprises, their investment behaviours may be further restricted by some targeted provisions in some countries.

The investment policy of the host country plays an important role in foreign investors' deciding the final selection of FDI entry mode. Especially some European countries have put very high barrier in the restriction of M&A and their policies may set a limit in the share of some proportions that foreign investors are allowed to hold in joint ventures. Therefore, during the decision making process before actual investment, Chinese state-owned enterprises will need to study policies and regulations of the host country, and choose FDI entry mode correspondingly. The 'Treaty establishing a Constitution for Europe', which was signed by leaders of EU member states in 2004, modified foreign investment (including inward and outward investment) related policies and regulations of EU member states, and incorporated them into the same framework for European trade. Unfortunately, this treaty has not taken effect officially by so far. Taking financial industry as an example, all of the four major Chinese state-owned commercial banks have business operations in Europe. But many EU countries have clear restrictions toward foreign financial institutes, which greatly cumber Chinese banks' business expansions in EU. With strict policy limits, it is very difficult for Chinese banks to obtain licences of universal banks in UK. Policies of Greece and Italy also impose negative impacts to China's wholly owned banks. Under such situation, therefore, M&A mode of entry is a better choice for Chinese commercial banks. China Development Bank has already started its M&A operations in EU and made an excellent example for other Chinese financial institutes by acquiring 7% stocks of Barclay UK.

As for other highly sensitive industries like resource, Radio and TV broadcasting, air transport, Some EU countries, such as Poland, Spain, Hungary, Sweden, have certain entry restrictions. Due to the uniqueness of Chinese state-owned enterprise as the main investing body, more requirements are imposed on to these firms besides merely obtaining investment authorization from related departments. Chinese state-owned firms which are investing in Hungarian Radio and TV broadcasting sectors and Swedish resource area will have to take M&A form as their FDI entry mode and the amount of

stock shares they are holding are restricted. Similar policies and regulations could also be found in Spain. These policies and regulations will inevitably impact the selection of investment entry mode during China's state-owned enterprises' decision making process.

In addition to certain policies and regulations which affect the selection of FDI entry mode, a part of EU member states directly set restrictions for cross-border M&A and Greenfield investments. In the recent years, Chinese state-owned enterprises are getting increasingly enthusiastic about using M&A mode to enter foreign markets. But on the contrary, EU member states have begun to take obvious measures of promulgating corresponding investment policies with reasons of security. Regarding Greenfield investment mode, firms seeking for establish wholly owned subsidiaries in Sweden need specific authorization from local authorities.

For EU countries, however, to attract foreign investment is still a very important economic tool in accelerating growth. With this reason, many of them provide generous offers through making foreign investment friendly policies and regulations, as is shown in the table. So when Chinese state-owned enterprises are making decisions on what investment entry mode to choose, they should consider making full use of these preferential policies. But some of these special policies are only for domestic companies, and UK is an example in this case. Under this circumstances, merging with or acquiring domestic firms in the target country would be the best choice for Chinese companies.

## 2. Level of Economic Development and Marketization

Among the 27 EU member states, 15 old members like Germany, UK, France have comparatively higher level of economic development and marketization. Enterprises in

these countries are more likely to have technology and management system which could well match the standard for MNE development, and can be readily used by parent companies. As a result, when entering old EU member states' market, Chinese state-owned enterprises prefer to use M&A entry mode. As for new EU member states like Czech and Poland, whose economic development and industrialization level are relatively lagged behind, Chinese investors may favour Greenfield or wholly owned entry mode in order to utilize comparative price and cost advantages in this region.

### 3. Quality of Infrastructure

Infrastructure of good condition factor plays a very important role in attracting foreign investment. It is also a factor of significance in deciding FDI entry mode. Without good infrastructure, MNEs will inevitably face higher business operational costs and become frustrated in effectively allocating resources worldwide. Besides the advantage of accessing FDI of higher levels, well developed infrastructure in transportation, communication, energy, and power transmission etc. could also bring up the scale and quality of MNE's local operations. It creates a hardware environment for foreign firms' learning process and R&D, which consequently serves as an important incentive driving up the overall FDI attractiveness in the country. For one thing, as crucial factors in the investment decision making process of MNEs, infrastructure's maturity and quality are closely and positively connected with the overall amount of investment injection from abroad. For another thing, the maturity and quality of infrastructure make a contributing impact on the speed of knowledge transfer within a country. The better infrastructure a country has, the faster information will be delivered and the more foreign investors will be negatively affected by asymmetric information. On the contrary, the disadvantage of not having good infrastructural system can be reflected from higher transactional costs, asymmetric information availability, and lower efficiency of carrying out investment

plans of foreign investors. Most investing enterprises will prefer Greenfield mode when they want to enter countries with good infrastructures and M&A for others. Although infrastructure quality in new EU member states are less satisfied compared with those of former EU members, in recent years new EU members have also given a lot emphasis on building high quality infrastructures. Therefore, the future will definitely see a rapid development in M&A activities between Chinese state-owned enterprise and firms of new EU member states.

#### 4. Social and Cultural Background of Europe

European Union has numbers of highly developed economies in the world and social and cultural background of various kinds. As a nation with a long history and Eastern cultural background with European countries, China has much difference in cultural value, social structure, language and lifestyle when interact and communicate with European countries. This could also be an influencing factor that may bias the selection of FDI entry mode. Usually if the social and cultural background of the host country is close or similar with that of the investment origin country, wholly-owned entry mode will probably be more acceptable in the target market. Nowadays, under the background of globalization, the linkage of different countries' languages and culture is becoming unprecedentedly distinct, more and more interactions and communications opportunities have made FDI entry much easier than ever before. It is always wise to undertake Greenfield investment in countries which have good historical connections and use M&A method in countries which are not very familiar with. For instance, most new EU member states are geographically closer to China and some CIS countries have friendly connections in the history. As a consequence, these countries, to a certain degree, have similar identities with China and closer psychological distance than old EU member states, and therefore more welcome toward Chinese investors.

## 5. Local Partner

In M&A investment activities, if the business concept of a Chinese state-owned enterprise is coherent with its partner's, both sides would be motivated to work together and towards the same goal. If the choice of partner is inappropriate, it can be risky for the running of joint ventures and harm the co-operational relationship.

### **4.2.2 Advantage Transfer End Point Factors from China**

Factors from China's side mainly include domestic competition and policies. Commonly if the volume of domestic market is big enough for firms' potential development, firms will prefer to stay in domestic market. When they are expecting strict limits on their development space in domestic market, or excessive competitions, they will be thinking about exploring foreign market and going for FDI. Firms on this developing stage are mostly large enterprises and are able to afford themselves for overseas Greenfield projects. On the contrary, if the overall market value is not big enough and firms choose to go abroad at an early stage, their sizes are often smaller and this may make them in favour of M&A type investment entry strategy. Moreover, production resource availability, financial market development level, and government's investment policies will all cause impacts on firms' choice between wholly owned and joint venture.

Normally, investment policies of the (investment origin) mother country will not necessarily affect FDI entry mode selection of its domestic firms. However, Chinese state-owned enterprises have deep connection with central government, so they could

benefit from Chinese policies as well. When a kind of resource is in urgent need, Chinese National Development and Reform Commission will usually bring in a special government fund in direct supporting state-owned energy enterprises to invest in foreign energy assets.

Apart from policies and regulations of EU member states, China's own investment policies also have strong leading effect in Chinese state-owned enterprises' selection of FDI entry modes. In 2004, according to '*Notice of the State Development and Reform Commission and the Export-Import Bank of China on Relevant Issues on Providing Credit Supports to the Key Overseas Investment Projects Encouraged by the State*', the State Development and Reform Commission and the Export-Import Bank of China together began to provide credit supports to Chinese firms overseas investment activities. Besides Greenfield form, the key overseas investment projects mentioned in the notice also includes large scale overseas M&A projects which could quickly enhance enterprise international competitiveness and expand potential foreign markets. As many cross-border merger and acquisition operations are taken in the form of international competitive bidding, these investment friendly policies will no doubt become a strong support and encouragement in promoting China's FDI.

Meanwhile, China's State-owned Assets Supervision and Administration Commission serves as a supervisor towards key investment projects of central enterprises. Documents like '*Notice of the State-owned Assets Supervision and Administration Commission of the State Council on Strengthening Administration over the Foreign Investment Activities of Central Enterprises*' has clarified and simplified the procedure of submitting applications of prospective investment projects, which may also imply the investment entry mode selection preference.

### 4.3 Conclusion of Chapter

Under the framework of foreign direct investment theories, this chapter treated Chinese state enterprises as ordinary MNEs and attempted to categorize possible FDI influencing factors into two groups: advantage transfer start point factors and advantage transfer end factors. In this chapter, the paper put Chinese state-owned enterprises into standard entry mode influencing factor selection procedure and analyzed potential influencing factors from both internal and external side in detail. Factors are listed in **Table 4-2**.

**Table 4-2 FDI Entry Mode Influencing Factors (CSOE as Ordinary Companies)**

<i>Advantage Transfer Start Point Factors (Internal)</i>	<i>Advantage Transfer End Factors (External)</i>
Enterprise product and service factor	EU investment related laws, policies and regulations
Motivation	Level of Economic Development and Marketization
Developing strategy	Quality of Infrastructure in EU
Company performance	Social and Cultural Background of Europe
Investment experience in the host country	Local Partner
	Influencing Factors from Inside China



## **CHAPTER FIVE: SWOT ANALYSIS OF CHINESE STATE-OWNED ENTERPRISES IN EU FDI ENTRY MODE INFLUENCING FACTORS: CSOES AS GOVERNMENT ENTERPRISES**

After discussing the FDI entry mode influencing factors of Chinese state-owned enterprises as ordinary companies in the last chapter, we need to shift our attention to the uniqueness of these government-controlled enterprises. As a nation, China is different from all EU member states in its form of government; as a market, China regards itself as a unique socialist market economy. Thus, as a blend of government and market-based entity, Chinese state-owned enterprise has many special characteristics that other ordinary firms do not possess. Chapter Five will deal with the special characteristics of Chinese government enterprises. With the help of SWOT analysis methodology, the paper will examine advantages and disadvantages originated from Chinese state-owned enterprise as special government enterprises participating overseas investment operations. In the latter part of the chapter, a summary of potential opportunities and threats will be brought up to form a systematic SWOT study.

### **5.1 Special Characteristics of China's State-Owned Enterprises: Strengths and Weaknesses**

1. The most distinct characteristic of Chinese state-owned enterprises lies in its special ownership structure. Different from ordinary companies which are created base on

freedom of civil contracts, state-owned enterprises in China are founded on the basis of interest of entire state. All the people of China as a whole own the assets of the company or the major part of it. They are directly controlled by the central or local governments. For companies in China under such structure of ownership, they benefit from clear advantages of many aspects. As they are all founded and supported by Chinese government, their vision during decision making process and capability in investment operations are automatically set to a quite high level due to the government involvement. This also reflects their higher level of risk tolerance. However, being wholly-owned by 'all the people' and controlled by government may otherwise present difficulties for them. Rights, obligations implement and interest distribution corresponding to their owners, decision makers, business administrators, and workers can be ambiguous, and consequently hard to be bound with normal Civil Law.

Due to the unique ownership structure of Chinese state-owned enterprises, they always maintain an interdependent relationship with the government. Their aims of engagement into commercial activities reveal the will of Chinese government and could be beyond simple business objectives. As an effective tool of controlling and leading the country, the central government establishes state-owned enterprises to control national economy secure state stability, pursue high-tech industrial development and so on. In order to endow these firms with sufficient power, Chinese government gives them privileges to operate in certain concessionary and sensitive industries. Sometimes, such privileges mean monopoly. Even when state-owned enterprises encounter great setbacks, they will very often obtain huge financial aid and policy support. As a side effect of support from powerful government, every single move of China's state-owned enterprise overseas operation and their motives will be carefully watched over by of foreign governments. Political interference factor can be decisive during foreign investment

operations. In the case of merger negotiation between Chinalco (Aluminum Corporation of China Limited) and Rio Tinto, agreement finally came to be broken up by Rio Tinto. One of the important reasons behind the failure of the deal is Australian government's fear of losing its control power over the state mining industry against Beijing. In this sense, the 'insecure image' of Chinese state-owned enterprises could potentially remain as a disadvantage in international market competition.

Over years, Chinese government has played a key role in regulating large state-owned enterprises investing abroad. The selection of FDI entry mode, target sector, investment location and many other aspects are not simply decisions of state-owned enterprises according to market considerations. The government is usually involved in making investment plans and it directs the investment projects to fulfilling special objectives of China's long-term interests. In most cases, the state interests are in the form of gaining access to foreign technology, information, markets and natural resource reserves. As a consequent, there is a high possibility of state-owned enterprises which are seeking to take over larger foreign companies to secure support from the government.

2. In the management of state-owned enterprises, the central government respects a fundamental principle: 'to invigorate large enterprises while relaxing control over small ones'. The role of government in market economy is in general to offset the market failure and interfere in market adjustment for necessity. Due to historical reasons, however, in China, state-owned companies can be seen almost in every industry. In order not to disperse material and financial resources or to be pinned down by firms under adverse financial condition, Chinese government decided to focus their energy on the restructuring and development of major enterprises and leave minor ones to fend themselves. As a result, starting from 1980s, the reform of

state-owned enterprises has driven numbers of large state companies merge together and small firms go private. Integration and resource centralization enables the earlier leading companies in each field to transform into competitive flagships in overseas expansion. As we could see from the investing company list (**Table 5-1** in **Appendix**), nearly all existing Chinese state-owned enterprises participating foreign direct investment are large-scale corporations. Therefore, compared with other MNEs, China's state-owned enterprises were born with advantages of larger size and stronger risk resistance capability. National monopolistic positions give many of them the strength to seek for overseas development opportunities in fields and industries of varieties. Yet flagship size will not always guarantee their successful in foreign investment project. Lack of EU investment experience and international management skills have broken dreams of many Chinese state-owned enterprises. Moreover, insufficient high level employees and managerial personnel remain to be a difficult problem after entering EU market.

In general, high degree of resource centralization characteristic gives Chinese government enterprises clear ownership advantages over their products, services and brand recognition effect, which enable them to engage in global competition on a large variety of objects (technology, natural resource, and brands in most cases) and sectors. Often than not, objectives of large-scale Chinese state-owned enterprise overseas operations can be reflected in their entry mode choices in two folds: either to acquire technology and strategic resource by enter under M&A, or expand markets and establish R&D institutes with Greenfield entry form.

3. Policy support is a strong backing to government-owned enterprises in China. The central government has been playing a very active role in encouraging state-owned enterprises to absorb foreign technology and resource through M&A form. Besides existing policies on tax reduction and cross-border tariff agreements, the voice of

encouraging state-owned enterprises to ‘go outside’ has been heard frequently. In several occasions, Premier Jiabao Wen and Rongrong Li, Dean of State-owned Assets Supervision and Administration Commission of the State Council expressed their encouragement for state enterprises to invest abroad under the international stagnancy after 2008 world-wide financial crisis. An official notice was issued by SASAC in 2004 in order to create better investment policy and regulation environment for state enterprises with future overseas investment plans. Credit support and simplified FDI application procedure would surely promote the investment projects of China’s government enterprises. Policy and regulation may also serve as directions from the government in deciding state enterprises’ foreign strategies. Still it is needed to be pointed out that many Chinese state-owned enterprises have suffered huge loss from their FDI projects, which may potentially cause a negative impact to the rest national firms when they make decision about whether to take the challenge. More policies of FDI incentives should be in place.

4. Another characteristic of China’s state-owned enterprise is the privilege of special financing channels, including state financial allocation, national bank loans, and central government’s financing source from international market. Diversified financing channels provide strong and stable impulse to these firms and the whole industry. As a result, when these government firms are going global, they would be more economically independent in adopting wholly-owned Greenfield investment mode, as well as other modes with partnership involvement. But with larger financial stakes at hand, have Chinese state-owned enterprises made full use of it into investment? The answer is No. As the level of economic development increased, market economy became further mature, and international commercial competition upgraded onto higher level , the problem of economic inefficiency of Chinese state-owned enterprises have been gradually exposed to the public. Only in the year 2008, the loss from state enterprise overseas merger and acquisition actions totalled

200 billion RMB<sup>12</sup>, which is even larger than the scale of successful operations.

5. Most state-owned enterprises enjoy good reputation and reliability. This is not only because China's state enterprises have the central government as backing, but also for the reason that, in all countries, state-owned enterprises are much stronger in their viability than normal companies. They cannot go bankrupt as easily as private firms. Law in some countries even has provision claiming state-owned enterprises are not allowed to go bankrupt or change business direction without the permission organs of state power, parliament in most cases. Such satisfying stability characteristic would no doubt be very helpful in securing market positions and gaining trusts of partners in M&A and joint venture entry modes. Reputation advantage is not alone without incidentals. A weak point come hand in hand with the state enterprise's stability: the market exit barriers for state-owned enterprises are very high. This could be the causes of two potential disadvantageous outcomes. For one thing, better stability factor automatically make managers and workers in these enterprises lose competition pressure and their sense of crisis, which may lead to dangerous results. For another thing, stability factor make industrial restructuring of state-owned enterprises less possible. This could further deteriorate market change adaptability of these firms.

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<sup>12</sup> Source: Ministry of Commerce of the People's Republic of China Database

**Table 5-2 Special Characteristics of China's State-Owned Enterprises: Strengths and Weaknesses**

<i>Special Characteristics</i>	<i>Strengths</i>	<i>Weaknesses</i>
Special Ownership Structure	Chinese government support; broad vision; high risk tolerance sector advantage; privileges to operate in certain concessionary and sensitive sectors; legitimate monopoly; aid support after setbacks	Ambiguous bound between rights, obligations and interest distribution; hard to be bound with normal Civil Law 'insecure image'; possibility of political interference
Large-scale in Size, Resource Centralization	Monopolistic position in market; strong risk resistance capability	Lack of EU investment experience, international management skills, and high-class employees
Policy Support	Favourable policy preference	More FDI incentives policies needed
Privilege Of Special Financing Channels	Easy access to finance; strong and stable push to commercial development	Low financial efficiency; huge loss in overseas investment
Reputation and Reliability	Easier to secure market positions and nice credit standing	High exit barriers; reduce of competition pressure; less possibility of restructuring

## **5.2 Opportunities and Threats of China's State-Owned Enterprises in EU**

The analysis of Chinese state-owned enterprises' special characteristics helped us understand why these enterprises controlled by Chinese government different from other ordinary companies and where their strengths and weaknesses lie in. When put into the global market, Chinese state-owned enterprises must prepare themselves to face with the opportunities and threats derived from their unique positions. With a link to the earlier European market background analysis, the following part will be a study of the opportunities and threats to be faced with.

### **5.2.1 Opportunities of China's State-Owned Enterprises in EU**

1. China's persistent economic growth and years of positive foreign reserves has bestowed Chinese state-owned enterprises sufficient financial backup to take steps outside. Survival of the fittest principle has entitled the existing state-owned enterprises in China winners from decades of native market competition. They have accumulated large amount of assets and capital available for investment potentials. Industries especially like electric appliance have already seized comparative advantages and met conditions to invest abroad. For them, in order to keep developing and remain competitive, utilizing global resource and market environment is becoming the next strategic move consequentially.
2. Global financial crisis has presented increasing opportunities of merger and acquisition. Although the world is recovering from the financial crisis, post-crisis impacts still remain in EU, one of the victims who have suffered the most from the crisis. Some European companies, including a few number of world class



enterprises, are faced with unprecedented financial and operational stress. To get out of adverse situation, they have to put non-core assets on sale. For Chinese state-owned firms, these assets are not 'trash', but potential 'win-win' stakes as they could be helpful in promoting their own brands.

3. Deepening of globalization urges Chinese state-owned companies to take new challenges. After joining WTO in the beginning of the new century, with less business hurdles, Chinese government has been holding a very optimistic view in trading and bilateral investing with other members. The 2004 EU enlargement further reinforced the key role of EU on the international market and offered fair trade platforms for Chinese government investors and EU member states.
4. Chinese government-owned enterprise' investing in EU could offset the pressure of trade surplus and growing foreign reserves. China has seen a favourable balance in trading with EU for years. At the same time, investment inflow from EU has also outpaced the outflow. This made China under great pressure in Chinese RMB (Yuan) appreciation. What Beijing is urgently needed to do is to seek for a balance of capital flow rather than to keep accumulate capital. Investing in EU could effectively change the current trade imbalance, alleviate Yuan appreciation pressure, and improve foreign reserve use efficiency.
5. Another opportunity can be seen from demographic aspect. There are overseas Chinese in many of EU member states. Their cultural and psychological intimacy with China is a valuable asset in providing information on local culture and market. So in host countries with overseas Chinese concentration, they could potentially play important roles in ensuring Chinese firms' quick adaptation.

### **5.2.2 Threats of China's State-Owned Enterprises in EU**

1. Lack of overseas investment experience and managerial experts. The past decades could see Chinese state-owned enterprises' clear improvement in native enterprise managerial experience and technology development. When they are participating investment project abroad, however, their lack of experience and expertise in management is fully exposed. In order to cut costs, some companies even do not take standard procedure during investment process, M&A especially. For example, some enterprises do not even go through thorough study of the target company and market, which definitely leave high possibilities of risk; some entrepreneurs have too much faith in their foreign partner that they do not send managerial team or CFO but let their subsidiary run fully on its own. This is very likely to end with huge loss from asset misappropriation. In addition, short of managerial experts is another threat. Investing enterprises need experts of rich experience and managerial skills. Also these experts will have to be very familiar with the host country market and able to conduct effective communication with locals. Without reserves of expertise and experts of this kind, it is highly difficult for Chinese state-owned to recruit qualified experts in time when the investment projects are about to happen, which inevitably brings problems after completing the deal.
2. Integration difficulty arise from cultural difference contributes further to the threats in front of Chinese government. Chinese Confucianism-based managerial culture causes many challenges to concepts of freedom, equality, and human rights in European subsidiaries. Sometimes, Chinese national enterprises may bring even stronger Chinese enterprise managerial culture, like combination of market business and political interference. Therefore, integration difficulties and conflicts from culture different are especially serious for Chinese enterprises entering under M&A mode.

3. In addition, defects resulted from inefficient managerial and administrative structures have been causing losses for Chinese state-owned enterprises. Bureaucracy and capital escape are among typical defects. Affected by Chinese government organizing structure, state enterprises and entrepreneurs are majorly bureaucratic. Examination and approval procedure for foreign investment projects is usually complex and takes much time. As a result, investing enterprises are very likely to miss the best chance in carrying out their plans. Some entrepreneurs of Chinese state-owned enterprises are very much like politicians in their way of thinking: they prefer big projects with huge funding support, and the results must be good-looking as that would be added to their list of social contribution. Bureaucracy and low efficiency further lead Chinese state-owned enterprises into capital escapes predicaments. Every year, millions of investment funds are lost by Chinese state-owned enterprises during FDI activities due to factors of irresponsible management, ill-functioned administration, corruption and bankruptcy.
4. 'China threat' is becoming an increasingly important hurdle for Chinese state-owned enterprises. With Chinese enterprises' fast expansion active involvement into cross-border investment activities around the globe, the spectre of 'China threat' has been raised by some foreign powers. The most sensitive industry is natural resource. In recent years, Chinese state-owned natural resource oriented companies have frequently participate in overseas resource company bidding. China, as one of the world's largest resource consumers and at the same time, the biggest exporters and fastest growing economies, has attracted the attention of the whole world. The needs for large amount of natural resources and huge sum of purchases have made China 'an aggressive predator' in the world resource market. This is especially the case when Chinese state-owned enterprises are dealing with Western companies. In the cases of 2005 China National offshore Oil Corporation's (CNOOC) bidding for

Unocal and 2009 Chinalco's bidding for Australian Rio Tinto, political interference from the host country acted a crucial factor in leading the deals to failure. Likely, Chinese state-owned enterprises should be prepared themselves to deal with similar frustration in EU resource market.

5. Threats from other large multinational competitors. In general large foreign MNEs have huge sum of assets and lion share of international markets. They are equipped with outstanding financing capacity and technological and managerial advantages, and better understanding of the world market. Failed competition operation with these MNEs often means massive loss. In 2009, Chinalco lost billions of USD<sup>13</sup> in the bid for Rio Tinto against BMP.

**Table 5-3 Opportunities and Threats of China's State-Owned Enterprises in EU**

<i>Opportunities</i>	<i>Threats</i>
Benefit from Chinese growing economy, sufficient financial backup	Lack of overseas investment experience and managerial experts
Global financial crisis forces some foreign companies to sell assets at low prices	Integration difficulty; cultural difference
Deepening of globalization; lower trade barriers after joining WTO	Managerial and administrative imperfection; bureaucracy and capital escape
Offsetting the pressure of trade surplus and growing foreign reserves, and stress of Yuan appreciation	'China threat'; huge need for natural resources; aggressive expansions
Overseas Chinese ensuring Chinese firms' quick adaptation	Threats from foreign MNEs

<sup>13</sup> Exact number of Chinalco's loss has been unknown. According to CHINA SECRECY ON-LINE, the loss totaled 700 billion RMB (106 billion USD approximately).

### **5.3 Conclusion of Chapter**

The entire Chapter Five served as a SWOT framework in analyzing potential FDI entry mode influencing elements from the aspect of Chinese state-owned enterprises' uniqueness. Strengths and Weaknesses derived from special characteristics of China's government enterprises were first discussed. Then with reference the overall EU investment environment, the paper advanced SWOT analysis by proposing the opportunities and threats that Chinese state-owned enterprises may face during their FDI entry mode decision making process and the post-deal business running. Outcomes from SWOT analysis are listed in **Table 5-4** in **Appendix**.

## **CHAPTER SIX     INTEGRATED FRAMEWORK OF FDI ENTRY MODE SELECTION FOR CHINESE STATE-OWNED ENTERPRISES INVESTING IN EU AND FRAMEWORK APPLICATION BASED ON CASE STUDIES**

The main discussion of the last two chapters focused on finding potential FDI entry mode influencing factors for Chinese state-owned enterprises from two perspectives: as ordinary firms and special government-owned enterprises. To establish a framework of entry modeselection, we need to combine the findings from the two perspectives and extract the best combinations for the best fit FDI entry mode candidates, with a reference to the current patterns of entry modes which Chinese state-owned enterprises are using in EU.

Chapter Six consists of three major parts. The first part will be a summary of current FDI entry mode features of Chinese state-owned enterprises in EU. This part will serve as a reference background for the next part, where all the finding of previous discussion will be linked together and the final entry mode selection framework proposed. Case studies under the framework follow in the last part.

### **6.1    FDI Entry Mode Features of Chinese State-Owned Enterprises in EU**

China initialized large scale FDI in EU from 1980s. By so far, China Ocean Shipping Company (COSCO), China Minmetals Corporation, China General Technology Holding

(Genertec) have all made successes in their overseas investment experiences. Although entry modes of FDI which these companies have adopted are various, we could still grasp some similarities in their entry mode patterns. Through studies of China's FDI in EU, we could notice that the investment entry modes used by Chinese state-owned enterprises have some clear features. These features can be summarized as specific industry concentration feature, specific country concentration feature, investment strategy concentration feature, and investment stage concentration feature.

### 6.1.1 Specific Industry Concentration Feature

Chinese state-owned enterprises that belong to the same industry show clear similarities in some aspects during their investment activities.

#### 1. Automobile and Motor Cycle Industries

When entering EU, Chinese automobile and motor cycle firms all adopted M&A mode of entry.

**Table 6-1 Automobile and Motor Cycle Industry Chinese State-owned Enterprises FDI Projects after 2001**

<i>Enterprises Name</i>	<i>Time of M&amp;A</i>	<i>Acquiree</i>	<i>M&amp;A Type</i>	<i>New Company/Institute</i>
SAIC	2007	Ricardo 2010 UK	Wholly M&A	SAIC Motor UK Technical Center Limited
NAC	2005	MG-Rover UK	Partly M&A	NAC MG-Rover
QianJiang Motor	2005	Benelli Italy	-	Qianjiang Europe Co., Ltd

Source: Release of Country/Region Report on China's Outward Investment Promotion. And SAIC Official website: <http://www.saicgroup.com/Chinese/sqjt/gsj/s/>

The results of these M&A investment projects turned out to be quite satisfying. As can be seen from the **Table 6-1**, in 2005, NAC (Nanjing Automobile Corporation) offered 5.3 million Pounds and successfully acquired famous British Automobile Company MG-Rover and its engine producing facilities. In the same year, Qianjiang Motor European Branch became the major share holder of Italian Benelli motor cycle company and transform it to a production base for high quality motor cycle exports. In 2007, SAIC (Shanghai Automotive Industry Corporation) bought out Ricardo research joint venture and has become the key player in SAIC Motor UK Technical Center Limited. European car producing technology has been in the world's cutting edge for decades. Acquiring European automobile manufacture is not only of great significance in stabilizing and exploring the local market, but also strengthens future risk resistance ability of Chinese automobile enterprises. Meanwhile, these acquisition operations let Chinese car makers gain the core technology of the acquire company and could apply it immediately to their own products. After acquisitions, SAIC and NAC both released new car models in European market, and were satisfied with the performances.

## 2. Transportation Services

Transportation service is the mainstay industry among Chinese state-owned enterprises FDI projects. China Ocean Shipping Company (COSCO), China Shipping Company, China National Aviation Holding Company (CNAH) all have large amount of FDI stock in EU nations. These transportation enterprises have demonstrated strong preference in choosing the investment mode. With no exceptions, they selected wholly owned as the major investment form. Take COSCO for example, among its 15 European branches, 12 are wholly owned by COSCO. The investment mode selection here is closely linked with enterprises' product attributes and their global and regional development strategies.



By gaining direct control over branches around the world, large MNEs in transportation industry will be able to maintain an advantageous position.

### 3. Financial Industry

Currently the four major Chinese commercial banks and PICC (the People's Insurance Company of China) all have FDI operations in EU member states. At the beginning stage of investment, most of these financial institutes first set up wholly owned representative offices. After a period when the business network had been generally established, they on the one hand upgraded these representative offices to branches, and on the other hand, used Greenfield mode to create business branches in other region. M&A mode seems not much in use by banks. For example, Bank of China has owned six branches in EU, the most among all the Chinese state-owned banks.

### 4. Electric Appliance

At present, major state-owned electronic appliance producers who are participating in EU investment are TCL Corporation, Changhong Electric Corporation and Hisense.

From the **Table 6-2**, we could see that TCL used M&A in Europe while the other two companies both chose Greenfield mode. TCL Corporations acquired Germany electronic company Schneider in 2002 and later in the early 2004 French Thomson, a leading electric appliance producer in EU. The reason for TCL's expansion under M&A mode is to gain immediate access to foreign technology and internationally recognized brand.

In the year 2004, Hisense established a Greenfield joint venture in Hungary. One year later, another partly owned venture was built by Hisense in France. These two production bases mainly produce HD and LED high quality digital TV products. Its sales distribution network covers most of EU member states. In 2007, Changhong established its European base in Czech for electric appliance production. The initial investment injection was over 10 million US dollars, which was the largest Chinese FDI in Czech and also the first independently owned overseas production base in the history of Chinese electric appliance industry. These Greenfield FDI projects helped Changhong and Hisense to overstep EU trade barrier, avoid anti-dumping inspections, and most importantly integrated European market and fortified company competitiveness in Europe. So, in all, FDI projects of Changhong Electric Appliance and Hisense can be seen as successful cases.

**Table 6-2 Electric Appliance Industry Chinese State-owned Enterprises FDI Projects after 2001**

<i>Enterprise</i>	<i>Host Country</i>	<i>Time</i>	<i>FDI Entry Mode</i>
TCL	Germany	2002	Wholly-owned M&A
TCL	France	2004	Wholly-owned M&A
Hisense	Hungary	2004	Partly-owned Greenfield
Hisense	France	2005	Greenfield
Changhong Electric Corp	Czech	2007	Wholly-owned Greenfield

Source: Hisense official website: <http://www.hisense.com> and Changhong official website: <http://www.changhong.com.cn/changhong/china/7920.htm>

### **6.1.2 Specific Country Concentration Feature**

When several Chinese state-owned enterprises invest in the same country, their FDI entry modes are quite similar. The reason is that FDI mode choice is to a very large degree decided by the host country's economic development level, foreign investment policies, and level of control over foreign investment. Evidence lies in the fact that when investing in new EU member states, China's state-owned enterprises are in favour of Greenfield mode. M&A is preferred in FDI projects taken place in old EU member states.

Chinese enterprises FDI modes used in Italy is a very typical example of country concentration feature. Before 2003, according to common practice of Italian official administrations (under the principle of reciprocity), Chinese companies were not allowed to establish wholly owned subsidiaries within Italy but had to co-operate with Italian firms and form joint ventures together or transfer the investment through other EU countries. As a consequence, when first entering Italian market, most Chinese enterprises used M&A mode. Later they began to gradually buy in all their stocks and turn back to wholly owned form. After 2003, new Italian investment policies granted permission for Chinese firms to establish wholly owned subsidiaries. By far the major FDI entry mode of Chinese FDI in Italy is wholly owned Greenfield.

Another case indicating China's state-owned enterprises FDI entry mode feature is about investing in UK. Before the year 2000, Chinese firms in UK all adopted Greenfield mode of entry, and they showed strong preference in wholly-owned ownership structure. Before establishment of official subsidiaries, Chinese enterprises normally set up representative offices. The function of representative office is to collect overseas market information and initialize contacts and business relationship with local market and firms in the meanwhile of seeking for co-operation opportunities. After three

to five years of preparation, some Chinese enterprises began to establish their subsidiaries in UK. This is partly due to the supervision of Chinese government on China's state-owned enterprises overseas FDI activities. This also reflects Chinese firms' general characteristics at the beginning stage of internationalization. The main function of early established representative offices and institutes is just an information window without clear competitiveness.

### **6.1.3 Investment Strategy Concentration Feature**

Enterprises with similar investment strategies tend to be in favour of the same FDI entry mode. If an MNE has strong demand in the control power over its foreign subsidiaries, its FDI projects will definitely show a strong preference in acquiring stocks. Typical industries are transportation industry and financial industry. Enterprises looking for strategic reform will usually adopt M&A to offset their location limitation disadvantages. Convincing evidence is FDI projects of China Minmetals Corporation and CNBM (China National Building Material Group Corporation).

On 1 June 2007, CNBM signed the contract and officially acquired Germany large-scale wind turbine blade producer NOI. Chinese wind power companies have been trapped technologically in design wind powered equipment. By using M&A investment mode, Chinese state-owned wind power firms could introduce, digest and absorb foreign advanced technology. CNBM official announced that after this international acquisition, CNBM would be able to realize its goal of transforming into a wind power industrial platform with R&D, design and production capability integrated.

#### 6.1.4 Investment Stage Concentration Feature

Some pioneer Chinese state-owned enterprises have already started to invest in Europe from 1980s. At early stage of investment, most of these firms used forms of representative office or agency, such as China Minmetals Corporation and China Ocean Shipping Corporation. After accumulating investment experience in the region and expanding business network, they began to establish subsidiaries. As Chinese state-owned enterprises began to locate their regional headquarters in Europe, which directly control and plan European business branch. By so far, China Minmetals Corp, COSCO, SINOCHEM (China Sinochem Group Corporation), SAIC, Hisense, Changhong Electric Corp, and China Telecom have all had European headquarter and established a whole systematic business network.

**Table 6-3 Part of Chinese State-owned Enterprises FDI Operation Statistics**

<i>Time</i>	<i>Investment Amount</i>	<i>Acquirer</i>	<i>Target Company</i>
May 2008	-	China Minmetals	HP Tec Germany
July 2007	1.45 Billion GBP	China Development Bank	Barclay UK
Jan 2007	-	CNBM	NOI Germany
May 2005	3.5 Million DM	HMCT	KELCH Germany
Nov 2001	615 Million USD	ZOOMLION	POWERMOLE UK

Source: Websites of Economic and Commercial Counsellors' Office of The Mission of the People's Republic of China to the European Communities, HMCT, China Minmetals Corporation and ZOOMLION.

In the new century, as the competitiveness of China's state-owned enterprises is growing rapidly, an increasing number of cross-border M&A have taken place. A wider range of industries and larger amount of funding are involved in these international

M&A operations, as can be seen from the **Table 6-3**. On 27 November 2001, ZOOMLION (Changsha Zoomlion Heavy Industry Science & Technology Development Corporation) successfully acquired the world famous British trenchless machinery company POWERMOLE. This M&A case brought in 20-year more advanced technology for Chinese trenchless machinery firms and made ZOOMLION an internationally reputed MNE. It also greatly encouraged all Chinese state-owned enterprises seeking for outward investment.

## **6.2 Framework of FDI Entry Mode Selection for Chinese State-Owned Enterprises Investing in EU**

In order to offer optimum choice for Chinese state enterprise owners in selecting FDI entry mode to EU, the framework of entry mode should be able to cover all the advantages and special characteristics. Therefore, the following part will attempt to build linkages between Chinese state enterprises' universality and uniqueness in deciding FDI entry mode.

### **6.2.1 Optimum Entry Mode Selection Analysis: Based on CSOE Internal Factors**

Internal entry mode influencing factors of Chinese state enterprises need to take into account of advantage transfer start point factors (CSOE as ordinary enterprises) and their STRENGTHS (CSOE as special enterprises), as is shown in **Table 6-4** in **Appendix**.

Study and comparison of the elements from advantage transfer start point and STRENGTHS in the **Table 6-4** gave us the inference that there are overlapping

concerning aspects about FDI entry mode influencing factors from both sides: concerns of sector advantage, technology demand, natural resource demand, EU investment experience, and expansion strategy. These concerns are the fundamental controllers during entry mode decision making process. Consequently it gives the paper reasoning backup in further investigating the choice of FDI entry mode and building up of the final framework.

1. When investing in EU, Chinese state-owned enterprises in machinery, textile, light industry and electric appliance sectors should adopt wholly-owned Greenfield or partly-owned Greenfield investment mode.

High level of competition has already existed within these sectors in China, which drives these national companies to shift their attention to the outside world. As Chinese Yuan has been appreciating against Euro, EU market entry barrier seems getting increasingly difficult to overstep for Chinese exporters. Producing and selling directly from inside the target market is becoming an alternative trend for Chinese light industrial manufacturers. With the aim of transferring their product advantage to outside markets, China's state-owned enterprises are seeking for opportunities to own producing base in EU member states. Greenfield investment mode may serve as a good choice for their first investment. At present, Chinese electric appliance firms have already set up production factories in France, Czech, Hungary and etc. Most of these overseas factories have been so far functioning well and can be used as live successful investment examples for other investors.

Although the number of China's state-owned enterprises investing in new EU members is small, what can be predicted is that FDI of Chinese manufacturing industry in the region will inevitably increase. Establishing overseas factories and production bases

will be the main focus in the long run. From the ownership aspect, wholly-owned investment mode will be the dominant trend. This is because the electric appliance industry has reached a status of saturation, which is at the stage of maturity in the product's cycle. Chinese state-owned enterprises in these industries possess capabilities of producing high standard products and therefore their aim is to explore foreign markets rather than to obtain foreign technology. Under wholly-owned investment mode, transfer of technology, knowledge and management advantages can be internalized. If there is restriction in FDI equity holdings, Chinese state manufacturing enterprises could use partly-owned Greenfield mode.

2. It is wise for technology and innovation oriented Chinese government enterprises to enter EU under M&A form.

One of the most important motives for Chinese state-owned enterprises investing in EU is the urgent demand for advanced technology, distribution channel and management experience. Normally two ways are available in accessing to these assets. One way is to directly acquire the technology of the target. Another way is to move into an advanced technology and management concentrated cluster area. With such clusters, MNEs can use the experts inside to train the employees of their own company, in order to get accessed to the desired expertise and technology and further obtain independent R&D capability. Traditional EU member states can be 'the cluster' here as they are generally advanced technology holders. Therefore M&A entry mode of FDI is a proper method under these markets. By adopting M&A, Chinese state-owned enterprises could combine EU strong points of advanced technology and an open, integrated market with other benefits like time saving and lower entry barrier and risks.

In addition, R&D oriented FDI is becoming a trend of investment mode for China's



state-owned enterprises under the world's globalization background. M&A FDI of Chinese state-owned enterprises has been used as a typical and successful example of catch-up investment strategy, which greatly promoted the enthusiasm of Chinese firms. Firms of automobile and motor cycle industries have already had M&A cases with R&D institutes in EU. Moreover electric appliance sector also saw the establishment of Chinese R&D centres. Acquisition of European R&D institutes could reward parent companies of quick involvement in product and technology's R&D as well as previous research achievement and experienced experts. This is a big step forward in building a systematic enterprise structure for Chinese state-owned firms on an international level. If no R&D institutes are available or are not able to meet the technology demand, Chinese state-owned enterprises may begin with establishing R&D department of smaller scales. Many European countries like Austria, Denmark, Italy, and UK have special offers in attracting FDI for R&D operations. France and Ireland use favourable tax policies in calling for R&D investment. So if China's state-owned enterprises could make full use of these friendly investment policies, they will be able to make better decision in choosing the most appropriate FDI entry mode.

3. Partly-owned M&A mode would benefit Chinese state enterprises with the aim of access to foreign natural resource reserves for risk diversion and fast entry.

Natural resource oriented type of outward investment has been an emphasis of China's FDI activities. Access to foreign natural resource could offset the lack of certain natural resource situation in China and consequently make great contribution in economic development. However, most countries have strict restrictions in natural resource exploration as is mentioned previously. So it is very unlikely that either Greenfield or wholly owned investment mode could easily apply to the energy sector. On the contrary, M&A or partly owned mode has turned out to be very practical. Firms of energy sector

are usually huge-scale in assets and financing foundation. They are bearing much higher risks and expecting long term development cycles. M&A and joint venture modes allow participating Chinese companies to share the large amount of input for natural resource exploration, and further more establish a stable and trusted co-operation relationship with the host country. Once the long-term relationship is established, it will be easier for firms from both sides to hedge risks and maintain stable supply of available resource.

In addition, many enterprises of EU member states are stock holders of natural resource exploration firms in many other countries and even some large natural resource development projects in developing countries. Collaborating or acquiring these EU enterprises is also an indirect way of gaining access to natural resource in other regions. Wide participation in exploring natural resource across countries will be of great strategic significance in the long run.

4. Chinese state-owned enterprises with more EU investment experience would prefer the mode of Greenfield. By accumulating investment experience, firms can make more accurate development plans for themselves. Moreover, rich experience helps them to gain a better understanding of European economy, society, and culture. They will also become much more familiar with investment laws and regulations, standard procedure in investment operations. Thus, they will gain and demonstrate an overall advantage in independent production and management. However, due to the fact that the majority of Chinese state-owned enterprises are in short of EU investment experience, M&A entry mode is demonstrating its attraction to most Chinese government-controlled firms when they go global and to EU.

5. From global investment strategy perspective, Chinese state-owned enterprises with

globalisation development strategies are recommended to employ wholly-owned Greenfield, which emphasizes the control power of parent companies in order to achieve optimum energy coordination and allocation as well as the synergy of all subsidiaries around the globe. On the other side, those Chinese state firms with localization strategies would be advised to use partly-owned M&A. This type of entry mode combination features enterprises in quick response to changes in local markets. Partly-owned M&A also means more power allowed and decentralized to local subsidiary companies, and thereafter, smoothes their business relation network unfolding with local suppliers, clients and governments.

#### **6.2.2 Optimum Entry Mode Selection Analysis: Based on CSOE External Factors**

Similarly to CSOE internal factors discussed above, external entry mode influencing factors of Chinese state enterprises are consisted of advantage transfer end point factors (CSOE as ordinary enterprises) and their OPPORTUNITIES (CSOE as special enterprises), which can be seen in **Table 6-5**.

**Table 6-5 External entry mode influencing factors of CSOE in EU**

<i>External entry mode influencing factors of CSOE in EU</i>	
<i>Advantage Transfer End Point Factors</i>	<i>Opportunities</i>
1.EU investment related laws, policies and regulations 2.Level of Economic Development and Marketization 3.Quality of Infrastructure in EU 4.Social and Cultural Background of Europe 5.Local Partner 6.Influencing Factors from Inside China	1. Benefit from Chinese growing economy, sufficient financial backup. 2.Global financial crisis forces some foreign companies to sell assets at low prices. 3. Deepening of globalization; lower trade barriers after joining WTO. 4. Offsetting the pressure of trade surplus and growing foreign reserves, and stress of Yuan appreciation. 5. Overseas Chinese ensuring Chinese firms' quick adaptation.

The integration of external entry mode influencing factors intend to answer the question: Go to emerging markets of new members or traditional EU members?

In the current investment stage, the most obvious and crucial motive of Chinese state-owned enterprises in EU is to obtain either advanced technological and managerial expertise or brand effect. As most high-tech and advanced managerial clusters are concentrated mostly in traditional EU powers, M&A is becoming an increasingly predominant form of FDI entry used by Chinese state-owned firms in Western European countries. Cultural difference further contributes to Chinese investors' choice of M&A as it helps Chinese firms to get familiar with local culture starting from their partners.

Emerging economies in EU, nevertheless, have their own unique attractions for Chinese

state enterprises. In comparison with that in traditional EU powers, production and operation costs in new EU members are cheaper and entry barriers are lower. The region can be taken as a starting point for integrating the whole European market. If we take all these factors into account, together with the friendly investment policies, it is safe to arrive at the conclusion that for Chinese state-owned enterprises, new EU member states have the most potential for Greenfield projects. One of the reasons is due to historical similarities. Many of new EU member states transformed from socialist economies and therefore have a closer psychological distance with Chinese culture.

The idea of first investing in new EU member states and expanding after, however, is not perfect. Economic and political instability of some markets may expose investing bodies to risks. Some countries may have restrictions on company asset holdings. With these concerns, Chinese state-owned firms should think of entering with M&A mode. M&A here will be a wise strategy in helping developing the host country and eventually achieve win-win outcomes. Only through sincere willingness of cooperation and positive participation, Chinese state-owned enterprises could be accepted in the local market.

### **6.2.3 Final Framework Integration**

After conducting a comprehensive analysis of FDI entry mode concerns, we could propose a final framework of FDI entry mode selection for Chinese state-owned enterprises investing in EU, as is demonstrated in **Table 6-6**.

**Table 6-6 Framework of FDI entry mode selection for Chinese state-owned enterprises investing in EU**

<i>Entry Modes</i>	<i>Greenfield</i>	<i>M&amp;A</i>
<i>Wholly-owned</i>	CSOEs of globalisation development strategies	-----
<i>Partly-owned (joint venture)</i>	-----	1. Natural resource oriented CSOEs 2. CSOEs of localization development strategies
<i>Either wholly or partly owned</i>	1. CSOEs of manufacturing Sectors (machinery, textile, light industry and electric appliance) 2. CSOEs of rich EU investment experience 3. CSOE investing in Eastern Europe	1. Technology and innovation oriented CSOEs; Brand effect oriented CSOEs 2. CSOEs investing in Western Europe

In general, FDI entry mode selection for Chinese state-owned enterprises investing in EU is a process of considering the influencing controllers above. The optimum entry mode choice is based on the following suggestions in brief:

1. Chinese state-owned enterprises in machinery, textile, light industry and electric appliance sectors should take wholly-owned Greenfield or partly-owned Greenfield investment when entering EU market.
2. Technology, innovation, and brand effect oriented Chinese government enterprises

are advised to go under M&A.

3. Chinese state enterprises with the aim of access to foreign natural resource reserves could be most benefited from partly-owned M&A entry mode.

4. Chinese state-owned enterprises with more EU investment experience are in advantageous positions in employing Greenfield.

5. Chinese state-owned enterprises with globalisation development strategies are recommended to employ wholly-owned Greenfield while Chinese state firms with localization strategies would be advised to use partly-owned M&A

6. Chinese state-owned enterprises with purposes to gain access to Western European high-tech clusters should adopt M&A; other state-owned enterprises with gradual expansion strategy should go Greenfield in EU emerging markets.

#### **6.2.4 Potential Challenges and Reacting Solutions: Based on WT Study**

Similarly to the logic of positive FDI influencing contributor selection, we need to see challenges that might be aroused from Chinese state-owned enterprises' weaknesses and external threats, and how to overcome these potential challenges. **Table 6-7** is a summary of previous outcomes from Chinese state-owned enterprises SWOT study, on negative side WT.

**Table 6-7 Potential Challenges of Chinese state-owned enterprises (WT study)**

<i>Weaknesses (W)</i>	<i>Threats (T)</i>	<i>Concerning Aspects</i>
Ownership ambiguity	Integration difficulty, Cultural difference	<b><i>Structural Defect</i></b>
Insecure image	‘China Threat’	
Low efficiency Low competition pressure	Bureaucracy, Capital escape	
Short of EU investment experience and high-class employees	Lack of experience and experts	<b><i>Low level of internationalization</i></b>
More policy incentives needed	Foreign MNE competitors	<b><i>External challenges</i></b>

As we could see from **Table 6-7**, the negative impacts derived from Chinese state-owned enterprises’ weaknesses and threats are primarily concerning three aspects: structural defect, low level of internationalization, and external challenges.

Challenges such as ownership ambiguity, insecure image, and inefficiency are mainly rooted in the structural defect of Chinese state-owned enterprise. Apart from pushing support, the presence of government influence on the other hand brings in bureaucracy and conflict possibility culturally and politically. Former investing operations initiated by resource seeking Chinese state-owned enterprise are good examples in demonstrating Chinese firms’ disadvantages. Defect from ownership structure, as a clearly special characteristic, is nearly impossible to be changed. However, there are still feasible solutions in diluting the displeasure that it may cause. When Chinese government officials are looking for overseas investment opportunities, especially in fields of strategic energy and technology, medium state enterprises or even private firms with



outstanding record might also be good alternatives for large-scale state-owned enterprises. Their smaller size and lower level of connection to Beijing would on the one hand offset the negative influence from 'China threat' among foreign government, and on the other hand would reinforce them with strong sense of improving market competitiveness and surviving foreign competitors.

In addition to structural defect, low level of internationalization has been another reason for Chinese state-owned enterprises' potential challenges during investing in EU. It is reflected as shortage of investment experience and employees of expertise widely among Chinese government companies. Therefore, before making decision on market entry, Chinese investors should first consult with reliable consulting firms and try to make accurate assessment over the prospective FDI projects.

Last but not least, challenges caused by external factors should also be treated with proper reactions. As many foreign competitors of Chinese state-owned enterprises are internationally monopolistic firms, it will be wise for Chinese government to provide further policy support not only for large-scale state enterprises but also medium and small size government-controlled firms in order to ensure positive outcomes of state-owned companies' overseas activities. Besides favourable policies and regulations on trade, finance and taxation, central and local government may use other tools in backing up state owned enterprises, for instance, providing timely investment information, technology support, and overseas investment risk insurance aid.

### **6.3 Avoiding Mistakes during Entry Mode Decision Making Process, TCL Case Study**

#### **6.3.1 Company Introduction and Case Background<sup>14</sup>**

TCL Corporation (known as TCL) is a multinational electronic appliance producer based in Huizhou, China. When the company was first established in 1981, it was a small-scale producer of cassette tapes. It transformed into a mass electronic products provider by expanding its business to telephone in 1985 and television in 1992. After years of effort, TCL made itself widely recognized as the largest state-owned television manufacturer in China and also a joint venture with several Hong Kong investors. Today TCL has distribution channels throughout the world and sells electronic products under four brands.

As a leading television manufacture and a lion share holder of Chinese television market, TCL had its technique and product quality recognized by OEM contracts with internationally famous companies such as Philips, Toshiba and Bang & Olufsen. For the reason of import quotas and high tariffs, however, TCL did not find good ways to enter European and North American markets. Nonetheless, in many occasions, the Chairman and CEO of TCL Li Dongsheng, representing TCL management, had voiced TCL's goal to 'become a Chinese Sony or Samsung',<sup>15</sup>.

In order to circumvent Europe's barriers of import quotas, in 2002 TCL made its bold move in Germany by acquiring the insolvent Schneider Electronics, which is a veteran television manufacture, for € 8 million. The purchase included equipment, stocks, technology and brand of Schneider Electronics. To TCL, the most valuable asset of

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<sup>14</sup>Source of case data: *The Risk Analysis of TCL Merger and Acquisition Thomson Company*. By TengHai.

<sup>15</sup>"The Struggle of the Champions," *Economist*, January 8, 2005, 57–59.

Schneider Electronics is its brand and the brand recognition value. According to the contract however, production activity of Schneider is to continue for at least two more years. This actually means that TCL will have to wait for a rather long period in transforming Schneider assets to its own advantages.

Later in 2003, ambitious TCL investors saw their next opportunity in Europe. French television manufacturer Thomson Electronics, who suffered financial setbacks, was seeking for partners to resuscitate its business. As Thomson is also the owner of the well-known brand RCA in the United States, TCL managers believed that this would be their best chance to breach trade barriers of European and North American markets simultaneously.

TCL formed strategic alliance with Thomson and together they established TCL-Thomson Electronics (TTE), the world's largest television manufacturer, where TCL owned 67% of its shares. This marked one major leap forward of TCL in exploring overseas market. It also helped Li Dongsheng win the respect of industry leaders and media. Fortune Magazine even named him as 'Asian Businessman of the Year' for 2003. The merger gave TCL access to Thomson's labour and distribution channels in France as well as its production facilities in other markets. In addition, agreement for the use of common designs for chassis and chipsets was confirmed. With these valuable resources achieved through merger, management executives of both sides touted the improved production efficiency and international influence of the joint venture.

Before TCL investors began to realize that they were far too optimistic about the outcomes of foreign investment, unfortunately, they switched their attention to the mobile phone arm of Alcatel, another unprofitable brand. Alcatel was the world's largest supplier of broadband Internet equipment. In August 2004, TCL and Alcatel formed a \$110 million joint venture where TCL held a 55% stake of it. The newly created firm

allowed TCL to strive into vast European market of mobile phone manufacturing and vending. Yet this international marriage proved to be short-lived, for even less than one year. Citing reasons of losses (\$45.7 million in first quarter 2005) and management discord, Alcatel managements finally decided to back out of the joint venture and eventually sold all of its stake to TCL in May 2005. As one Alcatel senior executive lamented, ‘the cultural differences between the two companies were huge ... there was no synergy at all.’<sup>16</sup>

Meanwhile, ambitious Chinese investors did not hear much good news of the TCL-Thomson Electronics as its profitability status looked so bad that it even dragged down TCL’s own performance. TCL’s net profits fell by half in 2004 to \$41 million. TCL’s CFO Yan admitted on the one-year anniversary of the strategic alliance, ‘in the past months of operations, we found out the challenges and difficulties are deeper than we thought.’<sup>17</sup> TCL officers announced a surprising loss of \$12.4 million during the first half of the year 2005. \$42 loss caused by Thomson’s operation in the United States and Europe made up a major part of the deficit. As a consequence, the original plan of making TTE profitable by 2005 was pushed back by two years to 2007.

### **6.3.2 TCL Entry Mode Selection Using the Framework and Analysis of the Investment Failure with French Thomson**

As a Chinese state-owned enterprise, TCL produces electric appliance (televisions and telephones) as main products. In the M&A case of TCL with French Thomson, TCL selected partly-owned M&A as FDI entry mode to EU. The key incentive is the core-technology and brand recognition effect of Thomson in Europe. TCL’s development strategy is localization in EU. Before the M&A deal took place in 2003,

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<sup>16</sup> Wu, F., (2005), *The Globalization of Corporate China*, NBR Analysis. 16(3)

<sup>17</sup> Wu, F., (2005), *The Globalization of Corporate China*, NBR Analysis. 16(3)

TCL's last and first investment is with German Schneider Electronics in 2002. So TCL should be regarded as an enterprise without sufficient EU investment experience. Investment projects took place in France, Western Europe. These are the basic facts needed in employing the FDI entry mode framework proposed in this paper. Now we have a table indicating the Framework suggested entry mode combination and the mode TCL used in reality.

**Table 6-8 Comparison of Entry Mode Choice between Framework Theoretical Inference and TCL's Actual Choice**

<i><b>TCL's Facts and Investment Influencing Factors</b></i>	<i><b>Theoretical Entry Mode Suggested</b></i>	<i><b>Same (√) or Difference () With The Actual Choice of Entry Mode (M&amp;A)</b></i>
Sector: Electric Appliance	Greenfield	X
Motive: Technology-oriented, Brand effect	M&A	√
Strategy: Localization	M&A	√
Location: France, Western Europe	M&A	√
Experience: Insufficient Experience	M&A	√

From the table above, we could see the choices of FDI entry mode are mostly the same between theoretical results and actual choice. As an electronic appliance producer, TCL did not choose Greenfield but M&A in its investment in France. This seems to contradict the outcomes of the Framework, but in this case, TCL's main purpose or motive is to obtain Thomson's technology and brand. This is different from most of other electric appliance investors whose aims are to merely expand markets.

Failure of TCL's investment could be summarized as two aspects.

### **Inaccurate Expectation of Target Company and Market**

Decisions of FDI entry mode selection is usually on the basis of a prospective growth rate of the target market. But in practice, the real rate of growth may turn out to be different from what has been expected before investment. Huge difference between the predicted market volume and the real market growth rate would lead to the wrong choice of investment entry mode and eventually failure of the entire project. For instance, if a company only sees the big European market without recognizing the real target group of customers, there is a high possibility that growth rate of market be predicted overoptimistically. This will definitely harm the company's practical performance. So during the FDI entry mode decision making stage, state-owned enterprises should make use of their advantages in collecting and processing market information and be scientific in evaluating future trend of the market.

Regarding cross-border M&A operations, highly influential international consulting firms have already been brought in by investing enterprises. These consulting firms offer reliable data source and former investment experiences. They are also familiar with foreign laws and policies and could make detailed and feasible plans. In order to have a precise grasp of the market situation during decision making process, Chinese state-owned enterprises should collaborate with reliable consulting firms.

In this case, TCL did not go to consult with any internationally famous consulting firms, and this, as a result, led to inaccurate expectations and the loss after. Besides, not only was there a vast difference in management styles of the two companies, but also the

acquired European firms were financially distressed and turned out to be less technologically-advanced than expected, especially in the area of flat-screen technology.

### **Insufficient Power of International Operation and Post-deal Integration**

Inaccurate expectation of target company and market further led TCL into difficulties post-deal integrations. In the case of the TCL-Thomson failed joint-venture, one Thomson senior executive lamented, *‘the cultural differences between the two companies were huge ... there was no synergy at all.’*

For MNEs, entry mode of FDI decision making takes place at the beginning stage of the investment operation though, it may cause decisive impact over the entire overseas process. Project managers and key personnel nominated should be patriotic, responsible, and dedicated to his or her job. Ordinary employees should better be recruited from locals in order to make good use of human resource. Localization management strategy is gaining popularity in recent years. Therefore, when making decisions on FDI entry mode selection, investors will need to assess the international operation power of the company. By company operation power here, it mainly includes the parent company’s independent operation power, operational power of the newly built company, and the change of such power after integration with other firms. It is a complex of all business factors on both internal and external, economic and political aspects. Chinese state-owned enterprise managers should pay special attention to their firms’ operation power after integrating with European companies with rich cultural background. Besides, international operation experience of European firms cannot be copied simply by moving experienced experts to new investment projects.

## **6.4 M&A, An Increasingly Popular FDI Entry Mode among Chinese State-owned Enterprises, MG-Rover Acquisition Case Study**

### **6.4.1 Case Background**

MG-Rover was the last domestically owned mass-production automobile manufacture in the UK. The company was established in the year 2000 when the Phoenix Consortium obtained the car-making and engine manufacturing assets of the original Rover Group from BMW. The following is a case about two Chinese state-owned automobile enterprises' M&A operation with Rover.

Enter EU market has been a wish for Chinese car makers for a long time, but very few actually did it. Reaching EU automobile quality standard proved to be too time-consuming for Chinese automobile players, most of who lacked the advanced technology in car quality and safety design but was impatient to cut a share in this world's richest market. Therefore, acquiring European automobile firms' technology and brands through merger and acquisition came to be a short cut in their sight.

In June 2004, the famous UK automobile brand MG Rover announced to establish a joint venture with its newly developed overseas business partner, named SAIC. SAIC is the abbreviation of Shanghai Automotive Industry Corporation, a Chinese state-owned enterprise. SAIC and MG Rover agreed to become allied to develop new models and technology with their joint effort. An even more encouraging piece of news broke out that the two companies had arrived at agreement of producing a million cars a year, with the production shared between MG Rover's Longbridge site and locations in China. SAIC were to invest £1 billion in exchange of 70% of the joint venture's total stake while MG Rover owning the rest 30%. However, the later cooperation did not always



go pleasant as before. Though SAIC successfully obtained the design and property rights for the Rover 25 and Rover 75 in early 2005, it subsequently lost out to another Chinese state-owned competitor, Nanjing Automobile Corporation (NAC), in a bidding for the use of MG Rover brand names and production facilities in Europe. Later in 2006, NAC forwarded its buying strategy with MG Rover by taking over its key assets. They also restarted MG sports car and sports saloon production in the year followed. With the technology obtained from MG Rover, SAIC developed its own brand Roewe in a few years later and put it into Chinese car market in 2006. However, NAC seems to be an even bigger winner in this case as it has made the acquisition deal closed successfully. After acquiring the famous Rover brand, NAC is able to use it as a base in Europe to build upon.

#### **6.4.2 Rationale and Implications**

Rationale behind the MG-Rover M&A case seems to be in the same logic with the entry mode framework provided in this paper. Both of the two Chinese state-owned automobile firms are very actively involved in M&A entry mode in EU. Although SAIC and NAC have different ways of utilizing the assets acquired, the logic behind their buying behaviour is the same: to gain immediate access of technology and existing brand. Acquisition would give them access not only to a target-company's products, but also to its technical knowledge, technology, brand and customer base. Automobile industry in China, at this point, is still on the early stage of international FDI process. Unlike foreign first-class automobile giants, Chinese government-owned carmakers do not possess core technological and brand advantages on a global scale. Chinese cars are characterized by cheap prices and low safety standards. Therefore, automobile manufacturers in China are keen in finding shortcuts in improving their products and technology. M&A entry mode has no doubt presented the most quick way in realizing

their goals.

Also, we should see Chinese government's role in facilitating the deal. The central government wants auto exports to increase substantially from 2005, and China's share of the global vehicle trade to climb to 10% between 2020 and 2035. Towards that end, it is helping automakers with funding—for example, by giving low-interest loans to Nanjing Automobile and SAIC to buy shares in the assets of MG Rover. The government is also introducing beneficial policies—for example, it will require automakers to apply for export licences from January 2007 onwards. This is intended to prevent undercutting on prices as China's domestic automakers export their vehicles because of over-production at home.

M&A case with MG-Rover initiated by SAIC and NAC is one of the successful ones. Both state-owned enterprises have benefited from their overseas FDI and transformed the technology obtained. This partly explained why M&A FDI entry mode has become increasingly popular for Chinese state-owned enterprises with urgent technology and brand recognition demand. However, whether SAIC (and NAC)<sup>18</sup> could completely absorb the technology and further make Rover profitable is yet unknown. Results can be only seen years later. But the merger of SAIC and NAC is very likely to form a solid foundation state-owned enterprise (largest Chinese automobile producer) of satisfying technology absorptive capability. However, the post-deal integration threat remains to be a potential problem in this case. For other technology demand government enterprises, accurate evaluation on M&A opportunity and post-deal integration risks should be carefully looked through before making entry mode decisions.

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<sup>18</sup> NAC was later acquired by SAIC in 2007. The MG-Rover brand has subsequently become part of SAIC asset.

## **6.5 Conclusion of Chapter**

Chapter Six, together with Chapter Four and Chapter Five, is a process of building a framework of FDI entry mode selection for Chinese state-owned enterprises. This chapter serves as the final integration part. It first examined features of current FDI entry mode used by Chinese government firms in EU. Then with reference to the previously selected influencing factors, the paper built the final entry mode framework with an emphasis of combinations of enterprises' advantage transfer start point factors and STRENGTHS, and advantage transfer end point factors and OPPORTUNITIES. Then cases of TCL Electronics and SAIC and NAC's acquisition with MG-Rover are used to illustrate potential threats during the FDI operation and M&A as an increasingly popular entry form for Chinese government investors.

## **CHAPTER SEVEN: CONCLUSION**

Under the general background of Chinese enterprises FDI in EU, although not in large scale, the total amount of investment appears to be growing rapidly. As the main force in the foreign investment activities, Chinese state-owned enterprises have the longest investment history, most experience and the largest scale among Chinese investing bodies. The issue of investment entry mode selection has been regarded as one of the most important questions that all investors need to answer during decision making process. Therefore, study of FDI entry mode selection is of great importance for entrepreneurs and investors. This paper takes China's state-owned enterprises as research target and set the main focus, or investment location, on EU member states.

Based on existing literature and FDI entry mode theories, this paper introduced the present FDI status of Chinese state-owned enterprises in EU and discussed FDI entry mode influencing factors from two angles: CSOE as ordinary firms and as special government enterprises. The paper used qualitative research methodology and SWOT analysis method to examine the factors which influence China's state-owned enterprises FDI in EU entry mode choices by building up a framework for the selection of possible FDI entry mode candidates. Main findings of this paper are as follows:

1. During the study on China's state-owned enterprises FDI entry mode selection, four features of Chinese firms' FDI modes are found in this paper. These features can be summarized as specific industry concentration feature, specific country

concentration feature, investment strategy concentration feature, and investment stage concentration feature

2. Under the framework of foreign direct investment theories, this chapter treated Chinese state enterprises as ordinary MNEs and attempted to categorize possible FDI influencing factors into two groups: advantage transfer start point factors and advantage transfer end factors. The paper put Chinese state-owned enterprises into standard entry mode influencing factor selection procedure and analyzed potential influencing factors from both internal and external sides in detail.
3. With a strong reference to the special characteristics of China's state enterprises, this paper adopted SWOT analysis method in examining the potential FDI entry mode influencing contributors derived from the uniqueness that is different from other regular companies.
4. The paper built up a FDI entry mode selection framework for Chinese state-owned enterprises investing in EU. The framework provided suggestions for Chinese entrepreneurs on clues of finding the optimum combination of FDI entry mode in Europe. Indications from the framework are:
  - A. Chinese state-owned enterprises in machinery, textile, light industry and electric appliance sectors should take wholly-owned Greenfield or partly-owned Greenfield investment when entering EU market.
  - B. Technology, innovation, and brand effect oriented Chinese government enterprises are advised to go under M&A.
  - C. Chinese state enterprises with the aim of access to foreign natural resource reserves could be most benefited from partly-owned M&A entry mode.
  - D. Chinese state-owned enterprises with more EU investment experience are in

advantageous positions in employing Greenfield.

- E. Chinese state-owned enterprises with globalisation development strategies are recommended to employ wholly-owned Greenfield while Chinese state firms with localization strategies would be advised to use partly-owned M&A
- F. Chinese state-owned enterprises with purposes to gain access to Western European high-tech clusters should adopt M&A; other state-owned enterprises with gradual expansion strategy should go Greenfield in EU emerging markets.

The paper and the framework are not without limitations. First, the framework is based on macro-level analysis and is able to provide a basic structure of reasoning for Chinese state-owned enterprises as a whole party or a specific sector. But on micro-level, the framework has its limitation in predicting the actual decision made by specific companies. Second, though enjoying a rocketing growth, China's FDI flow to EU initiated by state-owned enterprises consists only a small part of China's entire FDI. Number of the existing investing Chinese state enterprises in Europe has limited the research to be conducted on a quantitative basis.

The selection of FDI entry mode for Chinese state-owned Enterprises investing in EU is a complex issue. This paper attempted to make contributions to the investigation of entry mode selection by building a macro-level framework for Chinese state enterprises. Further research on this topic in the future could be advanced from perspectives of some specific sector.

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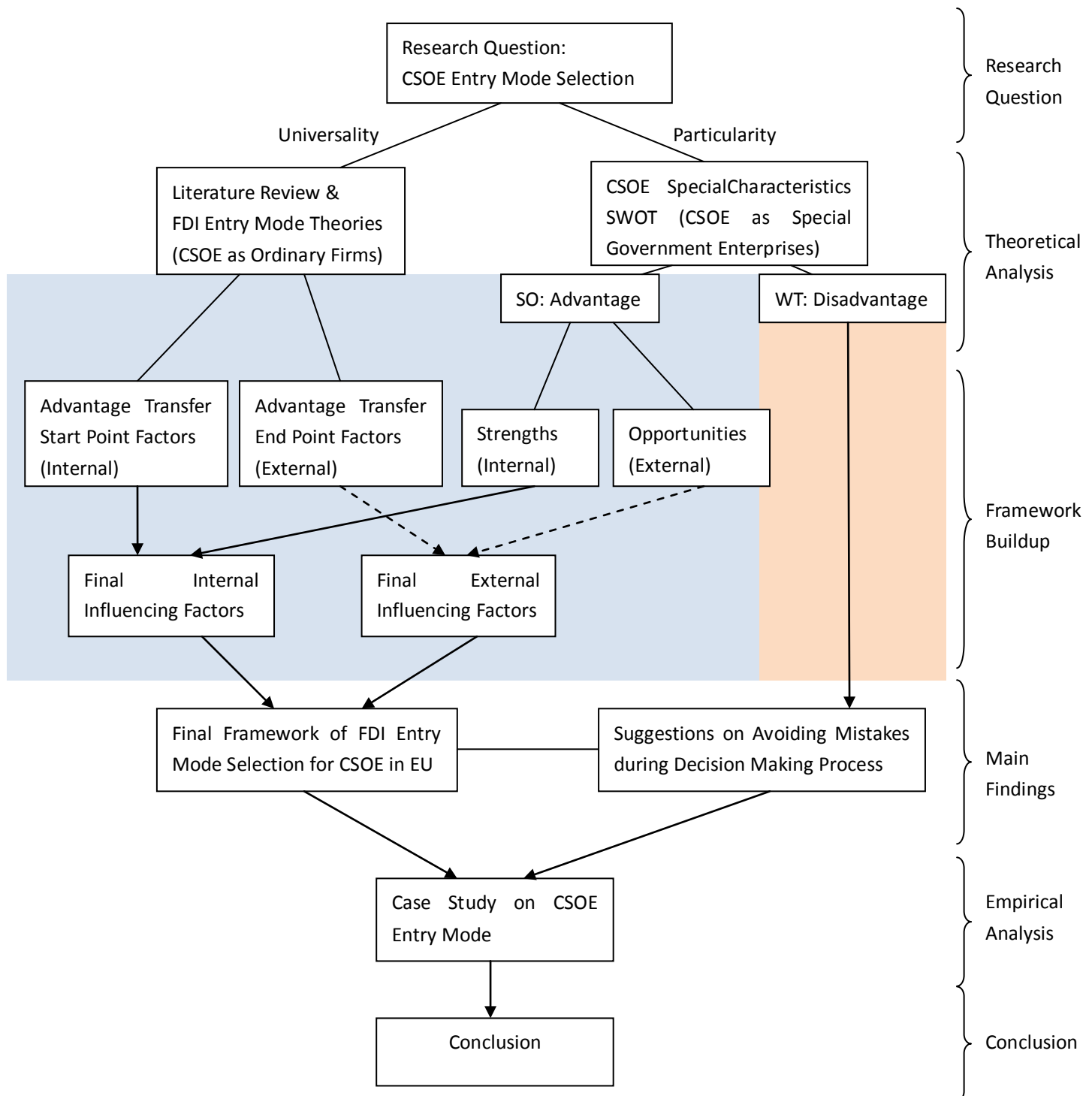
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## **APPENDIX**

**Chart 1-5 Research Structure**



**Table 3-1 Comparison of Greenfield and M&A**

<i>Aspects of Comparison</i>		<i>M&amp;A</i>	<i>Greenfield</i>
Investment Process	Range of Target Industry Selection	Technology and capital concentrated industries High entry & exit barrier industries	All industries
	Investment Cycle (Timeliness of Operation)	Good, requires less time	Requires a preparing period
	Financing Structure	Flexible, less input, various forms	Simplex, requires large amount of input
	Risk Control	Higher risk	Lower risk
	Investment Environment of the Host Country	More independent from the host country influence	Easier to be influenced by host country factors
Costs and Returns	Costs	Lower costs	Higher costs
	Returns	Higher returns	Lower returns
	Time Factor in Acquiring Strategic Resource	Faster access to strategic resource	Slower access to strategic resource
Influence to the Host Country	Macro-Economic Influence	Less support from locals, may not much enlarge local economy size, more potential collaborations	More support from locals, positive effect to local economy; may result in overlapping and redundancy
	Micro-Economic Influence	Maintain competition level	Possibility of a higher level of competition



**Table 3-2 Comparison of Wholly-owned Firm and Joint Venture**

<i>Aspects of Comparison</i>	<i>Wholly-owned Firm</i>	<i>Joint Venture</i>
Control Power	More control power	Less control power
Required Investment Size	Larger	Smaller
Risk Exposure	Higher risk	Lower risk
Investor Size	Larger	Smaller
Market Reaction Flexibility	Faster	Slower
Level of Classification	Higher level of classification	Lower level of classification
Influence from Host Country	Less support from locals	More support from locals

**Table 5-1 China's State-owned Enterprises FDI to EU Entry Mode Selection**

	<i>Year</i>	<i>Investment Enterprise</i>	<i>Sector</i>	<i>Mode of Entry</i>	<i>Target Company/ New Project</i>	<i>Host Country</i>
1	2001	ZOOMLION	Machinery Manufacturing	M&A	POWERMOLE UK	UK
2	2002	TCL	Electric Appliance	M&A	Schneider Electronics	Germany
3	2003	China Minmetals	Energy	Greenfield	Minmetals Spain Co Ltd	Spain
4	2004	Hisense	Electric Appliance	Greenfield	TV Production Base Hungary	Hungary
5	2004	TCL	Electric Appliance	M&A	Thomson	France
6	2005	Hisense	Electric Appliance	Greenfield	Production Base France	France
7	2005	HMCT <sup>1</sup>	Machinery Manufacturing	M&A	KELCH Germany	Germany
8	2005	NAC	Automobile	M&A	MG-Rover UK	UK
9	2005	Qianjiang Motor	Automobile	M&A	Benelli Italy	Italy
10	2006	China Telecom	Telecom	Greenfield	China Telecom (Europe) Corp	UK
11	2006	WISCO <sup>2</sup>	Iron and Steel	Greenfield	WISCO Europe Trade Corp	Germany
12	2006	NBE <sup>3</sup>	Electricity	Greenfield	NBE Sweden Co Ltd	Sweden
13	2007	Changhong Electric	Electric Appliance	Greenfield	Production Base Czech	Czech
14	2007	SAIC	Automobile	M&A	Ricardo 2010 UK	UK
15	2007	CNBM	Building Materials	M&A	NOI Germany	Germany
16	2007	China Development Bank	Finance	M&A	Barclay UK	UK
17	2007	Hisense	Electric Appliance	Greenfield	Hisense European R&D Center	Netherlands
18	2008	China Minmetals	Energy	M&A	HP Tec Germany	Germany
19	2009	Sinopec Group	Energy	M&A	Addax	Switzerland/Canada

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<sup>1</sup> HMCT: Harbin Measuring and Cutting Tool Group Corporation

<sup>2</sup> WISCO: Wuhan Iron and Steel Corporation

<sup>3</sup> NBE: National Bio Energy Co., Ltd.

**Table 5-4 SWOT Analysis of Chinese State-owned Enterprises Investing in EU**

<i><b>Strengths</b></i>	<i><b>Weaknesses</b></i>	<i><b>Opportunities</b></i>	<i><b>Threats</b></i>
<p>1. Chinese government support; broad vision; high risk tolerance.</p> <p>2. Sector advantage; privileges to operate in certain concessionary and sensitive industries; legitimate monopoly; aid support after setbacks.</p> <p>3. Monopolistic position in market; strong risk resistance capability.</p> <p>4. Favourable policy preference.</p> <p>5. Easy access to finance; strong and stable push to commercial development.</p> <p>6. Easier to secure market positions and nice credit standing.</p>	<p>1. Ambiguous bound between rights, obligations and interest distribution; hard to be bound with normal Civil Law.</p> <p>2. ‘Insecure image’; possibility of political interference.</p> <p>3. Lack of EU investment experience, international management skills, and high-class employees.</p> <p>4. More FDI incentives policies needed.</p> <p>5. Low financial efficiency; huge loss in overseas investment.</p> <p>6. High exit barriers; reduce of competition pressure; less possibility of restructuring.</p>	<p>1. Benefit from Chinese growing economy, sufficient financial backup.</p> <p>2. Global financial crisis forces some foreign companies to sell assets at low prices.</p> <p>3. Deepening of globalization; lower trade barriers after joining WTO.</p> <p>4. Offsetting the pressure of trade surplus and growing foreign reserves, and stress of Yuan appreciation.</p> <p>5. Overseas Chinese ensuring Chinese firms’ quick adaptation.</p>	<p>1. Lack of overseas investment experience and managerial experts.</p> <p>2. Integration difficulty; cultural difference.</p> <p>3. Managerial and administrative imperfection; bureaucracy and capital escape.</p> <p>4. ‘China threat’; huge need for natural resources; aggressive expansions.</p> <p>5. Threats from foreign MNEs.</p>

**Table 6-4 Internal entry mode influencing factors of CSOE in EU**

	<i>Internal entry mode influencing factors of CSOE in EU</i>	<i>Concerning Aspects</i>	<i>Impacts on G/M&amp;A Choice</i>	<i>Impacts on WOS/JV Choice</i>
<i>Advantage Transfer Start Point Factors</i>	Enterprise product and service factor	Product and sector advantage	√	√
	Motivation	Technology and resource pursuit, brand effect	√	√
	Developing strategy	Expansion strategy	√	√
	Company performance	Product and sector advantage	√	√
	Investment experience in the host country	Experience	√	√
<i>CSOE Special Characteristics: Strengths</i>	Special Ownership Structure	Sector advantage; encouragement on technology and resource pursuit	√	√
	Large-scale in Size, Resource Centralization	Ownership advantage; product and sector advantage	√	√

	Policy Support	Encouragement on technology and resource pursuit; expansion strategy	√	
	Prerogative Financing Channels	All aspects	√	√
	Reputation and Reliability	All aspects	√	√

**Source of Table 5-1:**

Release of Country/Region Report on China's Outward Investment Promotion. And SAIC Official website, websites of Economic and Commercial Counsellors' Office of The Mission of the People's Republic of China to the European Communities, Hisense, Changhong Electric Corporation, SAIC, HMCT, China Minmetals Corporation